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ARTICLE

CENTRAL CLEARING OF FINANCIAL CONTRACTS: THEORY AND REGULATORY IMPLICATIONS

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To protect economic stability, postcrisis regulation requires financial institutions to clear and settle most of their derivatives contracts through central counterparties,

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such as clearinghouses associated with securities exchanges. This Article asks whether regulators should expand the central clearing requirement to nonderivative financial contracts, such as loan agreements. This Article begins by theorizing how and why central clearing can reduce systemic risk. It then examines the theory's regulatory and economic efficiency implications, first for current requirements to centrally clear derivatives contracts and thereafter for deciding whether to extend those requirements to nonderivative contracts. The inquiry has real practical importance because the aggregate monetary exposure on nonderivative financial contracts—and thus the potential systemic risk that could be triggered by that exposure—greatly exceeds that on derivatives contracts. The inquiry also raises fundamental legal questions as to why (and the extent to which) regulators should tell financial institutions how to control risk and whether to require the mutualization of risk.

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INTRODUCTION

Since the global financial crisis of 2007–2009 (the “financial crisis”), an increasing number of countries, including the United States, have been requiring most derivatives contracts to be cleared¹ and settled² through central counterparties (CCPs).³ CCPs are typically well-capitalized entities,⁴ often associated with derivatives, commodities, or other securities exchanges.⁵ The CCP legally substitutes its credit for that of the contracting parties, making the CCP the primary counterparty on both sides of the contract—for example, the buyer to every seller and the seller to every buyer.⁶ The CCP thus ensures the

¹ Clearing is “the process of transmitting, reconciling and, in some cases, confirming transfer orders prior to settlement.” EUROPEAN CENT. BANK, GLOSSARY OF TERMS RELATED TO PAYMENT, CLEARING AND SETTLEMENT SYSTEMS 5 (2009), <https://www.ecb.europa.eu/pub/pdf/other/glossaryrelatedtopaymentclearingandsettlementsystems.pdf> [https://perma.cc/Q2YK-9EQV]. It involves identifying the obligations of the parties to the transaction.

² Settlement is “the completion of a transaction or of processing with the aim of discharging participants’ obligations through the transfer of funds and/or securities.” *Id.* at 24.

³ See *infra* notes 36–37 and accompanying text.

⁴ Rather than having large equity cushions, CCPs are usually indirectly capitalized through the resources of their clearing members. See *infra* notes 162–67 and accompanying text.

⁵ The three largest U.S. clearinghouses, for example, are CME Clearing Services, which provides clearing and settlement of exchange trades on the Chicago Mercantile Exchange and the Chicago Board of Trade; ICE Clear U.S., which is owned by Intercontinental Exchange, an entity that also owns the New York Stock Exchange; and LCH, which is a unit of the London Stock Exchange Group. See *Clearing Firms*, CME GROUP, <http://www.cmegroup.com/clearing/financial-and-regulatory-surveillance/clearing-firms.html?redirect=/tools-information/clearing-firms.html> [https://perma.cc/TPY2-2TBE]; Michelle Price, *Three Biggest U.S. Clearing Houses Pass Liquidity Stress Tests: CFTC*, REUTERS (Oct. 16, 2017, 12:08 AM), <https://www.reuters.com/article/us-cftc-clearing-tests/three-biggest-u-s-clearing-houses-pass-liquidity-stress-tests-cftc-idUSKBNiCL09Q> [https://perma.cc/6PJJ-A9SJ].

⁶ See PETER NORMAN, *THE RISK CONTROLLERS* 7–8 (2011); cf. R. BLISS & C. PAPATHANASSIOU, EUROPEAN CENT. BANK, *DERIVATIVES CLEARING, CENTRAL COUNTERPARTIES AND NOVATION: THE ECONOMIC IMPLICATIONS* 3 (2006), https://www.ecb.europa.eu/events/pdf/conferences/ccp/BlissPapathanassiou_final.pdf [https://perma.cc/95F2-MJZU] (observing that the original “bilateral contract between two market participants is replaced by two bilateral contracts between each of the original counterparties and the CCP”); Richard Squire, *Clearinghouses as Liquidity Partitioning*, 99 CORNELL L. REV. 857, 862 (2014) (“The clearinghouse interposes itself between the parties, serving as the counterparty to each. Instead of selling the cattle future to Buyer, Seller sells it to the clearinghouse,

performance of a financial contract even if a contracting party fails,⁷ thereby reducing counterparty risk⁸—the risk that a contracting party’s default will harm other parties to the contract. Regulators believe this reduction of counterparty risk will reduce “systemic” risk⁹—the risk that, in this context, a failure of one or more counterparties could lead to events that impair the financial system’s ability to function as a network¹⁰ and cause an economic collapse.¹¹

This emerging regulatory norm raises the question on which this Article focuses: should regulators also require other types of financial contracts (hereinafter “nonderivative financial contracts”) to be centrally cleared and settled, in order to reduce systemic risk?¹² This inquiry has real practical importance because the aggregate counterparty exposure¹³ on nonderivative

which sells an identical future to Buyer.”). The substitution of credit is legally referred to as a “novation,” which arises when a new party assumes a payment obligation that was incurred by a debtor on a contract and the original debtor is totally released from the obligation. 66 C.J.S. *Novation* § 1 (2019).

⁷ NORMAN, *supra* note 6, at 7.

⁸ *Id.* at 9. Central clearing more technically reduces counterparty credit risk, a type of counterparty risk that is sometimes called default risk.

⁹ The reduction of counterparty risk might reduce systemic risk but cannot eliminate it because counterparty failure is not the only cause of systemic risk. Other factors, such as the failure of financial markets, can trigger systemic risk. Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 200-02 (2008).

¹⁰ “Systemic risk” refers generally to the risk that the financial system could fail to function as a network. *Id.* at 204, 207-08. The term “macroprudential regulation” refers to regulation designed to mitigate systemic risk. Cf. Douglas J. Elliott, Greg Feldberg & Andreas Lehnert, *The History of Cyclical Macroprudential Policy in the United States* 6 (Fed. Reserve Bd., Finance and Economics Discussion Series No. 2013-29, 2013) (observing that the goal of macroprudential regulation “is to manage factors that could endanger the financial system as a whole, even if they would not be obvious as serious threats when viewed in the context of any single institution”); Robert Hockett, Implementing Macroprudential Finance-Oversight Policy: Legal Considerations 4 (Jan. 20, 2013) (unpublished draft prepared for the International Monetary Fund) (available at <https://ssrn.com/abstract=2340316>) (defining the term “macroprudential” as a “prefix [used] in finance-regulatory contexts, pertaining to the reduction of risks that imperil financial systems . . . as wholes”). In contrast, “microprudential” regulation “is concerned primarily with the safety and soundness of individual institutions, markets, or infrastructures.” Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Federal Reserve Bank of Chicago’s 47th Annual Conference on Bank Structure and Competition: Implementing a Macroprudential Approach to Supervision and Regulation 2 (May 5, 2011) (transcript available at <http://www.federalreserve.gov/newsevents/speech/bernanke20110505a.pdf> [<https://perma.cc/E7P5-Y7CV>]).

¹¹ The events that lead to that impairment are not limited to a domino-like collapse of financial institutions but could include changes in behavior of market participants in response to a counterparty’s failure.

¹² I first raised this question at the Federal Reserve Bank of Chicago workshop, Legal Arrangements for Cross-Border Resolution and Liquidity in OTC Derivative Markets: Theoretical Insights from “A Legal Theory of Finance” and Other Contemporary Perspectives, on June 14, 2014.

¹³ Counterparty exposure is the amount of default risk to which a counterparty is subject. *See, e.g., Counterparty Credit Exposure for Swaps*, FINANCIALCAD CORP., <http://www.fincad.com/resources/resource-library/article/counterparty-credit-exposure-swaps> [<https://perma.cc/DFC4-8ZT7>]. “Aggregate counterparty exposure” is the aggregate counterparty exposure after netting any offsetting counterparty obligations. The reader should not confuse that concept with the term “net aggregate liability,” which

financial contracts—and thus the systemic risk that could be triggered by that exposure—greatly exceeds that on derivatives contracts.¹⁴ Centrally clearing derivatives contracts through CCPs also has a “unique feature”: the “mutualization of default losses.”¹⁵ Expanding central clearing to nonderivative financial contracts therefore raises fundamental issues about whether regulators should require financial institutions to mutualize losses in order to control systemic risk.¹⁶

To answer its question, this Article first shows that regulators require central clearing of derivatives contracts because they assume—driven in part by media pressure—that those contracts are inherently systemically risky.¹⁷ This Article then explains why that assumption is misleading: the systemic riskiness of derivatives contracts comes not from their inherent nature but, rather, from their systemically important counterparties.¹⁸ Finally, this Article uses that insight to theorize and argue as to when regulation should require central clearing for nonderivative financial contracts.¹⁹

refers to a CCP finding itself liable for an amount that it cannot set off against its clearing members. See *infra* notes 167, 171 and accompanying text.

¹⁴ At yearend 2013, for example, the amount at risk (or “gross market value”) on outstanding bonds alone was \$91 trillion. SIFMA RESEARCH DEP’T, SEC. INDUS. & FIN. MKTS. ASS’N, 2017 FACT BOOK 55 (2017), http://www.lexisecuritiesmosaic.com/gateway/sec/public-statements/10_US-Fact-Book-2017-SIFMA.pdf [<https://perma.cc/9EER-KQZ5>]. That amount is many times larger than the \$19 trillion of risk exposure on derivatives. MONETARY & ECON. DEP’T, BANK FOR INT’L SETTLEMENTS, STATISTICAL RELEASE: OTC DERIVATIVE STATISTICS AT END-DECEMBER 2013, at 2 (2014), https://www.bis.org/publ/otc_hy1405.pdf [<https://perma.cc/DR2K-6UJG>]; cf. *Supervisory Policy and Guidance Topics: Credit Risk Management*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., https://www.federalreserve.gov/supervisionreg/topics/credit_risk.htm [<https://perma.cc/6U7C-L282>] (last updated Mar. 1, 2019) (“For most banks, loans are the largest and most obvious source of credit risk. However, there are other sources of credit risk both on and off the balance sheet [including] credit derivatives [and derivatives involving] foreign exchange . . .”). This Article later explains why gross market value, and not “notional amount,” is the proper metric for comparing risk exposure. See *infra* note 105.

¹⁵ Robert T. Cox & Robert S. Steigerwald, *A CCP Is a CCP Is a CCP* 1 (Fed. Reserve Bank of Chi., Working Paper No. PDP 2017-01, 2017). One reviewer of this Article called “the mutualisation of risk . . . one of the most important private ordering benefits of CCPs, one that is often overlook[ed].” Email Attachment from Paolo Saguato, Assistant Professor of Law, Antonin Scalia Law Sch., George Mason Univ., to author (Jan. 13, 2018, 8:51 PM) (on file with author).

¹⁶ Mutualizing a risk of loss (and hence the resulting losses) refers to dividing it among multiple parties to reduce the chance that its occurrence will cause significant financial loss to any one party. See *infra* note 214 and accompanying text.

¹⁷ See *infra* notes 29–39 and accompanying text.

¹⁸ See *infra* notes 40–59 and accompanying text.

¹⁹ Cf. *Theory*, OXFORD AMERICAN DICTIONARY (1980) (defining “theory” as “a set of ideas formulated (by reasoning from known facts) to explain something”).

A. Terminology

This analysis builds on the following foundational terminology. Consistent with financial industry shorthand, references to “clearing” also include settlement, and references to “central clearing” mean the clearing (and thus settlement) of contracts through CCPs. Central clearing of a nonderivative financial contract therefore means using a CCP to transmit, reconcile, and confirm each transfer to be made under the contract,²⁰ and then to complete the transfer by paying funds or assigning securities as needed to satisfy counterparty obligations thereunder.²¹ The term “counterparty” means, depending on the context, either the contracting parties themselves or a CCP acting as a central counterparty. Applying these terms, central clearing of a loan agreement—which exemplifies a straightforward nonderivative financial contract—means using a CCP (acting as a central counterparty) to monitor the amount and dates of payments to be made thereunder and to make each such payment, when due, to the (counterparty) lender on behalf of the (counterparty) borrower.²²

References to a “financial contract” mean any contract—exemplified above by a loan agreement—that governs a financial or financing transaction.²³ A derivatives contract is a specific type of financial contract: it is one that derives its value from the future performance of an underlying asset, index, or other reference entity.²⁴ In that sense, it is a “bet” on that future underlying performance.²⁵ For example, Party *A* may enter into a derivatives contract today to sell 1000 shares of *XYZ* stock, currently having a market value of \$70 per share, to Party *B* a year from now, at that same price. If in a year the market

²⁰ See *supra* note 1 and accompanying text (defining clearing of derivatives contracts).

²¹ See *supra* note 2 and accompanying text (defining settlement of derivatives contracts).

²² As discussed above, see *supra* text accompanying note 6, this reflects that the CCP legally substitutes its credit for that of the contracting parties, making the CCP the primary counterparty on both sides of the contract—in the case of loan agreements, the CCP serves as the lender to every borrower and the borrower to every lender.

²³ In principle, this Article addresses central clearing of any type of nonderivative financial contract. That includes not only loan agreements but also other standard types of financial contracts, such as bond indentures, commercial paper agreements, repo agreements, guarantees, and standby letters of credit, and perhaps even other types of contracts that allocate monetary risk such as insurance. Mutualizing insurance risk through CCPs, for example, might have the potential to replace state guarantee funds or even to reduce the need for reinsurance, which creates its own major risks. See Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. CHI. L. REV. 1569, 1613–18 (2014) (discussing the risks of the opaque reinsurance industry).

²⁴ Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1, 6 (2011).

²⁵ See *id.* (observing that derivatives contracts are “bets,” being “agreements between parties that one will pay the other a sum of money that is determined by whether or not a particular event occurs in the future”).

value of *XYZ* stock has fallen to \$50 per share, Party *A* would benefit.²⁶ But if that market value had instead risen to \$80 per share, Party *B* would benefit.²⁷

B. *Historical Context*

The move to require central clearing of derivatives contracts assumes that derivatives contracts are unusually systemically risky and, indeed, were a cause of the financial crisis.²⁸ The media portrayed American International Group (AIG)—which was potentially liable under multiple credit-default swaps (CDS), a type of derivatives contract,²⁹ to investors in mortgage-backed

²⁶ Party *A* could, for example, purchase the 1000 shares at \$50 per share and immediately resell them to Party *B* at the agreed-upon \$70 per share, making a \$20 per share profit. Or the parties could settle the contract by the simple payment of that net amount by Party *B* to Party *A*.

²⁷ In a parallel to the previous scenario, Party *B* could purchase the 1000 shares from *A* at \$70 per share and immediately resell them at \$80, making a \$10 per-share profit, or the parties could settle the contract by having Party *A* pay the net amount to Party *B*.

²⁸ See, e.g., ERNST & YOUNG, DODD-FRANK'S TITLE VII – OTC DERIVATIVES REFORM 1 (2013), [https://www.ey.com/Publication/vwLUAssets/Key_questions_board_members_should_ask_about_Title_VII/\\$FILE/Americas_FAAS_Dodd_Frank_derivatives_reform.pdf](https://www.ey.com/Publication/vwLUAssets/Key_questions_board_members_should_ask_about_Title_VII/$FILE/Americas_FAAS_Dodd_Frank_derivatives_reform.pdf) [<https://perma.cc/NV54-ZDJS>] (“Congress viewed the lack of regulation of OTC derivatives transactions as exacerbating the 2008 financial crisis . . . [s]ince the trades were not regulated, the amount of market participants’ exposures throughout the financial system could not be quantified Title VII aims to reduce systemic risk through mandating central clearing of previously unregulated derivative instruments . . .”). To some extent also, the move to require central clearing of derivatives contracts might indirectly respond to certain precrisis publicized losses on derivatives contracts, such as the highly publicized losses incurred by Orange County, California, and Gibson Greetings. Cf. Dan Awrey, *Toward a Supply-Side Theory of Financial Innovation*, 41 J. COMP. ECON. 401, 406 (2013) (observing that “a series of high profile derivatives-related scandals involving market participants such as Orange County [and] Gibson Greetings” prompted the Commodity Futures Trading Commission (CFTC) to issue “a Concept Release in May 1998 announcing its intention to fundamentally re-examine its approach toward the regulation of OTC derivatives markets . . . as part of a comprehensive reform effort designed to update the CFTC’s oversight of both exchange-traded and OTC derivatives markets” and seeking “comment on a number of specific areas of potential reform including” clearing).

²⁹ To understand a CDS, a special type of derivatives contract sometimes called a “credit derivative,” consider the example of Party *A* making a loan to Party *B*. If Party *A* is concerned about Party *B*’s ability to repay the loan, Party *A* (in this capacity, the protection buyer) may enter into a CDS contract with Party *C* (the protection seller) under which Party *C* agrees to make any payments that Party *B* fails to make. In exchange for this protection, Party *A* pays Party *C* a fee. See, e.g., *Understanding Investing: Credit Default Swaps*, PACIFIC INV. MGMT. CO., LLC, <https://www.pimco.com/en-us/resources/education/understanding-credit-default-swaps> [<https://perma.cc/934H-ZLRZ>]. Protection sellers may enter into many CDS contracts, thereby earning fee income while helping market participants to hedge risk. Although documented as a derivatives contract on International Swaps and Derivatives Association (ISDA) forms, a CDS contract is fundamentally a guarantee. Cf. Leonard Ng, *Credit Default Swaps, Guarantees and Insurance Policies: Same Effect, Different Treatment?*, 2010 BUTTERWORTHS J. INT’L BANKING & FIN. L. 664, 664-66 (observing that U.K. financial and insurance law treats CDS contracts and guarantees similarly in many important respects, in sharp contrast with how it treats “insurance contracts” with which they are sometimes confused).

securities (MBS)³⁰—as a “poster child” for that crisis.³¹ The collapse of the MBS market threatened AIG’s financial integrity as panicking investors commenced collection actions on their CDS contracts.³² Observers believe that, absent its government bailout, AIG would have collapsed and caused massive systemic harm.³³ Although his statement is often taken out of context, Warren Buffet added fuel to the fire by famously referring to derivatives contracts as “financial weapons of mass destruction.”³⁴

³⁰ See Christoph Henkel, *Harmonizing European Union Bank Resolution: Central Clearing of OTC Derivative Contracts Maintaining the Status Quo of Safe Harbors*, 22 *TRANSNAT’L L. & CONTEMP. PROBS.* 81, 97-98 (2013) (explaining that AIG was “unable to post sufficient collateral to ensure meeting its obligations under the majority of its CDS agreements,” leading to “a run on its collateral by its derivative counterparties and CDS protection buyers”); Stephen J. Lubben, *Repeal the Safe Harbors*, 18 *AM. BANKR. INST. L. REV.* 319, 320 (2010) (describing the AIG collapse as a “downward spiral”). At least some of those “investors” may not actually have owned MBS; instead, they directly or indirectly purchased protection under CDS contracts whose payments tied to MBS pricing.

³¹ See, e.g., Michael S. Barr & Joe Valenti, *Commentary: How the CFPB Fight Is a Sign of the Next Financial Crisis*, *FORTUNE* (Dec. 6, 2017), <http://fortune.com/2017/12/06/cfpb-director-mick-mulvaney-leandra-english> [<https://perma.cc/V6UG-L25Y>] (referring to AIG as the “poster child of the financial crisis”).

³² See Lubben, *supra* note 30, at 320. Ironically, the safe harbor provisions of U.S. bankruptcy law appear to have exacerbated AIG’s position by allowing counterparty suits to go forward notwithstanding the automatic stay, which suspends all litigation against an entity that has filed for bankruptcy. *Id.* These provisions give derivatives-contract counterparties “virtually unlimited enforcement rights against [a counterparty] debtor.” Steven L. Schwarcz, *Derivatives and Collateral: Balancing Remedies and Systemic Risk*, 2015 *U. ILL. L. REV.* 699, 700. This deprives a systemically important counterparty debtor of bankruptcy law’s protections, including the automatic stay, “thereby hastening [its] collapse.” *Id.* at 707. For that reason, I have argued that “the safe harbor’s application should be limited to remedies pursued by SIFIs against non-SIFIs.” See *id.* at 712, 718 (using the term “SIFI,” as is common, to refer to a systemically important financial institution).

³³ See Felix Salmon, *Why AIG Wasn’t Allowed to Fail*, *REUTERS* (Mar. 17, 2009), <http://blogs.reuters.com/felix-salmon/2009/03/17/why-aig-wasnt-allowed-to-fail> [<https://perma.cc/N6DW-2GKP>] (explaining that the government bailed out AIG as a result of the “systemic fragility of the CDS market” in order to prevent “a cascade of counterparty failures which could kill the entire financial system”).

³⁴ Letter from Warren E. Buffet, Chairman, Berkshire Hathaway Inc., to Shareholders of Berkshire Hathaway Inc. 15 (Feb. 21, 2003) (available at <http://www.berkshirehathaway.com/letters/2002pdf.pdf> [<https://perma.cc/L58B-PX84>]). The media has also suggested that Lehman Brothers’ derivatives contracts were unusually systemically risky. See, e.g., Jeffrey McCracken, *Lehman’s Chaotic Bankruptcy Filing Destroyed Billions in Value*, *WALL ST. J.* (Dec. 29, 2008, 12:01 AM ET), <https://www.wsj.com/articles/SB123050916770038267> (reporting that the early termination of Lehman Brothers’ derivatives contracts is estimated to have cost the firm approximately fifty billion dollars). Ironically, as in AIG, this cost instead resulted from the safe harbor provisions of U.S. bankruptcy law purporting to protect derivatives counterparties. Cf. *Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform (Part I): Hearing Before the Subcomm. on Commercial & Admin. Law of the H. Comm. on the Judiciary*, 111th Cong. 71-72 (2009) (statement of Harvey R. Miller, Lead Counsel for Lehman Brothers’ Bankruptcy, Weil, Gotshal & Manges LLP) (testifying that Lehman’s lack of automatic stay protection in bankruptcy, due to those safe harbor provisions, led to a state of confusion and chaos); Lubben, *supra* note 30, at 320 (observing that those safe harbor provisions exacerbated AIG’s position by allowing counterparty suits to go forward notwithstanding the automatic stay).

In response, the Dodd-Frank Act—the Congressional legislation that seeks to redress the excesses that led to the financial crisis³⁵—and followup regulation by the Securities and Exchange Commission (SEC) and CFTC require that many derivatives contracts be centrally cleared through CCPs.³⁶ In accord with recommendations of the Financial Stability Board, an organization established by the G20 nations to monitor and make recommendations about the global financial system, numerous jurisdictions outside the United States have similarly begun requiring central clearing of derivatives contracts.³⁷ If AIG's CDS contracts were centrally cleared, the argument goes, it would not have needed a government bailout.³⁸

In the first instance, the answer to this Article's question—whether regulators should also require nonderivative financial contracts to be centrally cleared—turns on understanding why derivatives contracts are systemically risky. If derivatives contracts are inherently systemically riskier than nonderivative financial contracts, then centrally clearing nonderivative financial contracts might only marginally reduce systemic risk. If, however, derivatives contracts are systemically risky because of a trait they share with nonderivative financial contracts, then it could be valuable to extend central clearing to nonderivative financial contracts that share that trait.

This Article's analysis proceeds as follows. Part I examines the systemic riskiness of financial contracts. It finds that derivatives contracts are not inherently systemically risky; rather, their systemic riskiness derives from their systemically important counterparties. Observing that nonderivative financial contracts sometimes also have systemically important counterparties, Part I then builds on that shared trait to derive a theory to explain when regulation should require central clearing of nonderivative financial contracts. Part II develops the theory by testing it against current regulation requiring the central clearing of derivatives contracts. Part III examines the theory's regulatory and economic efficiency implications for determining whether to expand central clearing to

³⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

³⁶ Title VII of the Dodd-Frank Act sets forth general requirements for derivatives, subsequently expanded through SEC and CFTC regulation. *See, e.g., Derivatives*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/spotlight/dodd-frank/derivatives.shtml> [<https://perma.cc/6J52-XYRC>] (last updated May 4, 2015).

³⁷ *See, e.g.,* RICHARD HECKINGER, IVANA RUFFINI & KIRSTIN WELLS, FED. RESERVE BANK OF CHI., UNDERSTANDING DERIVATIVES: MARKETS AND INFRASTRUCTURE 32 (2014), <https://www.chicagofed.org/-/media/publications/understanding-derivatives/understanding-derivatives-chapter-3-over-the-counter-derivatives-pdf.pdf?la=en> [<https://perma.cc/Z5DY-8YUF>] (summarizing the regulatory history of the central clearing mandate for derivatives contracts).

³⁸ *Cf. supra* notes 29–33 and accompanying text (discussing AIG's near failure). As this Article will explain, however, that begs the question whether the CCP would have needed a government bailout. *See infra* Part IV.

nonderivative financial contracts. It also identifies and balances the benefits and costs of such a regulatory expansion. Part IV examines how to limit the costs of expansion, including by adapting the protections against CCP risk concentration that currently apply to central clearing of derivatives contracts. It also examines how to enhance those protections. Part V focuses in depth on two fundamental legal questions raised by central clearing: whether regulators should mandate how financial institutions control risk, and whether they should require financial institutions to mutualize risk. Appendix 1 to this Article illustrates how nonderivative financial contracts could be centrally cleared and compares that to the central clearing of derivatives contracts. Finally, Appendix 2 explains how to standardize nonderivative financial contracts, showing that such standardization would be quite feasible because, among other reasons, nonderivative financial contracts already are commonly documented on standardized forms.

I. EXAMINING THE SYSTEMIC RISKINESS OF FINANCIAL CONTRACTS

As discussed, regulators assume that derivatives contracts are inherently systemically risky, suggesting that something about their nature creates that risk. That assumption, however, has never been rigorously tested. Section I.A examines the nature of derivatives contracts to explain their systemic riskiness. Thereafter, Section I.B uses insights from that inquiry to explain the potential systemic riskiness of nonderivative financial contracts.

A. *Explaining Why Derivatives Contracts Are Systemically Risky*

There are almost no formal studies of the inherent systemic riskiness of derivatives contracts,³⁹ much less studies comparing the systemic riskiness of derivatives and nonderivative financial contracts. Most of the discussion has been anecdotal. Some argue, for example, that derivatives contracts are especially systemically risky because derivatives are bets.⁴⁰ However, all financial contracts are bets. A loan agreement is a bet by a lender that the borrower will repay the loan on a timely basis with interest. Even a simple guarantee is a bet by the guarantor, in consideration of a guarantee fee, that the guaranteed obligation will not default.

Others suggest that derivatives contracts are especially systemically risky because derivatives are volatile: “[u]nlike other contracts, the value of [derivatives contracts] typically can change rapidly based on the fluctuating

³⁹ Compare studies cited *infra* notes 57–58 (supporting this Article’s explanation of why derivatives contracts are systemically risky), with Yesha Yadav, *The Problematic Case of Clearinghouses in Complex Markets*, 101 GEO. L.J. 387, 391 (2013) (discussing the inherent riskiness of credit-derivatives contracts, a special type of derivatives contract).

⁴⁰ Cf. *supra* note 25 and accompanying text (characterizing derivatives contracts as bets).

value of the underlying assets or collateral, prevailing market conditions and other factors.”⁴¹ Volatility in turn can create the possibility of indeterminate liability. Consider, for example, an interest-rate swap in which Party *A* exchanges its fixed interest-rate payments for Party *B*’s floating rate payments (based, for example, on LIBOR). If interest rates fall, Party *B* will take a loss that cannot be precisely quantified *ex ante* because it will depend on the magnitude of the interest-rate change.

Nonetheless, the parties usually can estimate the limits of their potential liability.⁴² In the interest-rate swap example, there is indeterminate liability insofar as the parties cannot know, when they enter into the derivatives contract, the sign (positive or negative) and magnitude of the interest-rate change. In reality, however, they will know from market experience and be able to model the likely maximum range of any interest-rate change within the timeframe of their contractual settlement date.⁴³ Similarly, in the example of Party *A* contracting to sell 1000 shares of XYZ stock to Party *B* a year hence at \$70 per share (its current market value),⁴⁴ there is indeterminate liability insofar as the parties cannot currently know the sign and magnitude of XYZ stock’s change in market value. In reality, again, they will know from market experience and be able to calculate the likely maximum range of any such change within the next year.⁴⁵ Furthermore, the derivatives contracts that some have identified as the most dangerous type—credit derivatives⁴⁶—actually have fairly precisely known maximum liabilities: in the case of a CDS guaranteeing repayment of a loan, for example, the maximum liability would be the principal and interest accruing on the loan through the settlement date.⁴⁷

⁴¹ *Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives: Hearing Before the Subcomm. on Regulatory Reform, Commercial & Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 40 (2014) (statement of Seth Grosshandler, Partner, Cleary Gottlieb Steen & Hamilton LLP).

⁴² See René M. Stulz, *Should We Fear Derivatives?*, J. ECON. PERSP., Summer 2004, at 173, 186 (observing that, “[s]ince 1994, regular users of derivatives have made considerable progress in measuring the risks of derivatives portfolios [and w]ith these tools, firms that use derivatives regularly know their risks reasonably well,” but cautioning that “these measurement tools do not always work well”).

⁴³ See, e.g., PAUL G. FERRARA & SEYED ALI NEZZAMODDINI, *INTEREST RATE SWAPS—AN EXPOSURE ANALYSIS* 26 (2013) (discussing how parties estimate their likely exposure to interest-rate change within the timeframe of their contractual settlement date).

⁴⁴ See *supra* text accompanying notes 25–27.

⁴⁵ Cf. *infra* note 52 and accompanying text (observing that accountants have devised a range of methodologies to estimate potential liability for even the most complex derivatives).

⁴⁶ See Yadav, *supra* note 39, at 391; see also *supra* note 29 and accompanying text (explaining credit derivatives).

⁴⁷ Cf. PRUDENTIAL FIN., INC., PRUDENTIAL FINANCIAL, INC. 2014 ANNUAL REPORT 206 (2015), <http://www3.prudential.com/annualreport/report2015/annual/images/Prudential-AR2014.pdf> [<https://perma.cc/X6TL-Y2NT>] (“The Company’s maximum amount at risk under [its] credit derivatives equals the aforementioned notional amounts [i.e., principal and interest on the underlying

Although the foregoing interest-rate swap and CDS examples (which reflect some of the most common types of derivatives contracts) are relatively simple, parties usually can estimate the limits of their potential liability even under much more complex derivatives. The disclosure of this liability is in fact an accounting requirement. Government securities regulators⁴⁸ have delegated to the accounting profession⁴⁹ the duty to disclose financial information—including information about the fair value of derivatives as either assets or liabilities⁵⁰—through formalized financial statements, such as balance sheets and income statements; the goal is to provide the “credib[ility], transparen[cy], and comparab[ility]” needed for “the efficient functioning of the economy.”⁵¹ To facilitate that required disclosure about derivatives liability, accountants have devised a range of methodologies to estimate potential liability for even the most complex derivatives.⁵²

obligations on which Prudential sold credit protection] and assumes the value of the underlying referenced securities [i.e., their principal and interest payable thereunder] become [sic] worthless.”).

⁴⁸ In the United States, the Securities and Exchange Commission. See Steven L. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319, 320, 346–47 (2002) (discussing the SEC’s delegation of disclosure power to the accounting profession).

⁴⁹ In the United States, to the Financial Accounting Standards Board, or FASB. *Id.*

⁵⁰ In the United States, this is governed by Financial Accounting Standard (FAS) No. 133, which “establishes accounting and reporting standards for derivative instruments” and “requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value.” See *Summary of Statement No. 133: Accounting for Derivative Instruments and Hedging Activities (Issued 6/98)*, FIN. ACCOUNTING STANDARDS BD., <http://www.fasb.org/st/summary/stsum133.shtml> [<https://perma.cc/ME5H-HCVQ>]. FAS 133 has been amended by FAS 161, which requires even further enhanced derivatives disclosure. See *Statement of Financial Accounting Standards No. 161: Disclosures About Derivative Instruments and Hedging Activities*, FIN. ACCT. SERIES (Fin. Accounting Standards Bd., Norwalk, Conn.), Mar. 2008, at 1.

⁵¹ FIN. ACCOUNTING STANDARDS BD., FACTS ABOUT FASB 1 (2007), <https://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175818791156&blobheader=application%2Fpdf> [<https://perma.cc/4AX6-TZ7W>].

⁵² See, e.g., ERNST & YOUNG, CREDIT VALUATION ADJUSTMENT FOR DERIVATIVES CONTRACTS 5-6 (2014), [https://www.ey.com/Publication/vwLUAssets/EY-credit-valuation-adjustments-for-derivative-contracts/\\$FILE/EY-Appling-FV-April-2014.pdf](https://www.ey.com/Publication/vwLUAssets/EY-credit-valuation-adjustments-for-derivative-contracts/$FILE/EY-Appling-FV-April-2014.pdf) [<https://perma.cc/S8CK-LQSH>]. This publication discusses various approaches for calculating valuation adjustments to value derivatives contracts fairly—fair value meaning in this context, as defined by International Financial Reporting Standards (IFRS) 13, “the price that would be . . . paid to transfer a liability in an orderly transaction between market participants at the measurement date.” *IFRS 13 Fair Value Measurement*, INT’L FIN. REPORTING STANDARDS, <https://www.ifrs.org/issued-standards/list-of-standards/ifrs-13-fair-value-measurement> [<https://perma.cc/V63G-9T6L>]. The Deloitte accounting firm defines fair value under IFRS 13 more intuitively as “how much the reporting entity has to pay to a market participant such that the market participant is willing to take over the liability.” DELOITTE LLP, CLEARLY IFRS—SUMMARY GUIDANCE AND PRACTICAL TIPS FOR IFRS 13 – FAIR VALUE MEASUREMENT 1 (2014), <https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/audit/ca-en-audit-clearly-ifrs-fair-value-measurement-ifrs-13.pdf> [<https://perma.cc/NJC9-XUAK>]. The “most advanced approach” is the Expected Future Exposure (EFE) approach, which is used by banks and other financial institutions with large derivative portfolios and can be “used for many types of derivatives.” ERNST & YOUNG, *supra*, at 5-6. Because the EFE approach “can be very complex and . . . needs to be

For these reasons, volatility alone does not make derivatives contracts systemically riskier than nonderivative financial contracts. That leaves only one other factor that can explain the systemic riskiness of derivatives contracts: most such contracts have at least one large⁵³ and highly interconnected⁵⁴ financial institution as a counterparty. The three main determinants of systemic risk are size, interconnectedness, and substitutability.⁵⁵ Having a large and highly interconnected financial institution as a counterparty (hereinafter, a “systemically important counterparty”) causes derivatives contracts to incorporate two of those three determinants of systemic risk.⁵⁶

The little research examining why derivatives contracts are systemically risky supports the view that their riskiness turns on the systemically important nature of their counterparties. Economists at the New York Federal Reserve Bank and finance scholars at Yale find, for example, that derivatives “create[] systemic risk” when the failure of a derivatives counterparty “could seriously impair the financial condition of one or more of its [systemically important] counterparties.”⁵⁷ No research appears to contradict that finding.⁵⁸

executed by quantitative experts and requires access to significant IT systems,” many firms “have adopted alternative approaches for estimating” liability on their derivatives contracts. *Id.*

⁵³ Cf. Franklin R. Edwards & Edward R. Morrison, *Derivatives and Systemic Risk: What Role Can the Bankruptcy Code Play?* (finding that relatively few banks effectively control the derivatives market, and that seven U.S. banks hold more than ninety-five percent of the U.S. notional derivatives exposure), in *SYSTEMIC FINANCIAL CRISES: RESOLVING LARGE BANK INSOLVENCIES* 347, 351 (Douglas D. Evanoff & George G. Kaufman eds., 2005).

⁵⁴ See, e.g., Christopher S. Dwight, Note, *Missed (Inter)Connections: Proposed Revisions to the Federal Reserve’s Approach to Financial Stability Analysis Under the Bank Holding Company Act*, 18 N.C. BANKING INST. 599, 603 (2014) (arguing that derivatives counterparties are highly interconnected because they engage in multiple transactions with other systemically important firms).

⁵⁵ See Schwarcz, *supra* note 32, at 704.

⁵⁶ Cf. James Bullard, President & Chief Executive Officer, Fed. Reserve Bank of St. Louis, *Systemic Risk and the Macroeconomy: An Attempt at Perspective* (Oct. 2, 2008) (transcript available at <https://www.stlouisfed.org/from-the-president/speeches-and-presentations/2008/systemic-risk-and-the-macroeconomy-an-attempt-at-perspective> [<https://perma.cc/JDD3-RJBM>]) (arguing that the failure of a large and highly interconnected counterparty can lead to a domino effect, setting off a pattern of failures among its counterparties). But cf. Rizwaan Jameel Mokal, *Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts*, 10 BROOK. J. CORP. FIN. & COM. L. 15, 15-16 (2015) (arguing that counterparty failure may not be a significant source of systemic risk, and that the “domino contagion view of distress . . . is theoretically flawed and empirically false” (internal quotation marks omitted)). Professor Mokal contends that the premise of the domino-effect risk, that “a significant market participant’s failure to meet its obligations would result in similar failures by its counterparties,” is a “relic of the [flawed] microprudential understanding of systemic risk”; among other hurdles, he maintains, a domino-effect collapse would require an implausibly large initial failure. *Id.* at 19.

⁵⁷ ROSALIND Z. WIGGINS & ANDREW METRICK, YALE SCH. OF MGMT., *THE LEHMAN BROTHERS BANKRUPTCY G: THE SPECIAL CASE OF DERIVATIVES* 15-16 (2014) (quoting with approval a New York Federal Reserve study).

⁵⁸ Although one study suggests that the “complexity and limited transparency of the [over-the-counter derivatives] market reinforced the potential for excessive risk-taking” and thus counterparty failure. See DARRELL DUFFIE, ADA LI & THEO LUBKE, FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 424,

B. *Explaining Why Nonderivative Financial Contracts
Could Be Systemically Risky*

The insight that the systemic riskiness of derivatives contracts turns on the nature of their counterparties, not on their inherent nature, indicates that nonderivative financial contracts with systemically important counterparties could also be systemically risky.⁵⁹ That presumes, of course, that the systemically important counterparty is exposed to counterparty risk.⁶⁰ That presumption should be valid because virtually all financial contracts—whether derivatives or nonderivatives—create counterparty risk, which results from the performance of obligations over time.⁶¹ Financial contracts depend on future performance.⁶² Even the simplest loan agreement, for example, depends on the borrower being able to repay principal and interest in the future.⁶³

Indeed, much of the financial institution counterparty risk that triggered the financial crisis arose under nonderivative financial contracts. Although some identify Lehman Brothers' bankruptcy as a cause of the financial crisis,⁶⁴ Lehman's counterparty risk first arose under MBS contracts, which are nonderivative financial contracts.⁶⁵ Lehman's counterparties began demanding

POLICY PERSPECTIVES ON OTC DERIVATIVES MARKET INFRASTRUCTURE 1 (2010) (suggesting that excessive risk taking by financial firms has a wide range of causes); *infra* note 145 and accompanying text. Moreover, over-the-counter (OTC) derivatives contracts are not always centrally cleared.

⁵⁹ Incongruously, the Dodd-Frank requirement to centrally clear derivatives contracts through CCPs applies whether or not a derivatives contract has any systemically important counterparties.

⁶⁰ *Cf.* NORMAN, *supra* note 6, at 7 (defining counterparty risk); *supra* note 8 and accompanying text (same).

⁶¹ *Cf. Law and Finance Workshop*, FED. RESERVE BANK OF CHI., <https://www.chicagofed.org/events/2014/law-finance-workshop> [<https://perma.cc/ZGN8-TSUA>] (last updated June 10, 2014) (stating that it "is the performance of obligations over time . . . which introduces the liquidity and counterparty credit risks at the heart of the contemporary policy debate surrounding the regulation of [derivatives] markets").

⁶² The exceptions are very limited, such as a "spot" contract, a subset of derivatives contracts in which the contract performance is immediate—such as a traveler exchanging U.S. dollars for euros at an airport at the then-posted exchange rate. *See, e.g., Spot Contracts – What Are They?*, TRADE FIN. GLOB., <https://www.tradefinanceglobal.com/currency/spot-contracts> [<https://perma.cc/L2BG-CPDY>].

⁶³ *See supra* text following note 40. One reviewer of this Article asked whether the fact that nonderivative financial contracts create "one-sided counterparty credit risk, while most derivatives present two-sided risk" might make derivatives contracts systemically riskier. It should not for at least two reasons. First, relatively more counterparties to derivatives contracts are systemically important, *see infra* note 75, so the likelihood any counterparty defaults is less than for nonsystemically important counterparties. Second, nonderivative financial contracts also effectively have two-sided risk. This Article focuses on the risk that a counterparty borrower defaults in repaying a systemically important counterparty lender, causing it to fail; but the counterparty borrower also bears the risk that its financial condition will deteriorate during the loan term, causing it to default.

⁶⁴ *See, e.g.,* Viral Acharya et al., *The Financial Crisis of 2007–2009: Causes and Remedies*, 18 FIN. MKTS. INSTITUTIONS & INSTRUMENTS 89, 93 (2009) (stating that Lehman's bankruptcy "led to the near collapse of the financial system").

⁶⁵ MBS are promissory notes backed by interests in mortgage loans. *See, e.g.,* U.S. Bank Nat'l Ass'n v. Ibanez, 941 N.E.2d 40, 51 (Mass. 2011) (stating that "mortgage loans are pooled together in

collateral out of concern that the collapse of the MBS market was causing Lehman's large MBS investments to become worthless.⁶⁶ Although Lehman filed for bankruptcy protection in response to those demands, the problems with Lehman's derivatives contracts arose only once Lehman went into bankruptcy.⁶⁷

Similarly, although the move to require central clearing of derivatives contracts assumes those contracts were a cause of the financial crisis,⁶⁸ derivatives-contract problems were more of an effect than a cause. CDS investors commenced collection actions against AIG because of the collapse of the MBS market.⁶⁹ They would not have done so absent that collapse because AIG would have been able to pay its liability on the CDS.

Observers also identify the failure of the repo market as a cause of the financial crisis.⁷⁰ Repos are nonderivative financial contracts—short-term secured loans couched as sales and repurchases of securities that serve as the collateral for the loan,⁷¹ not unlike a conditional sale agreement.⁷² Because the amount of the repo market is huge, scholars are beginning to argue for the central clearing of repo transactions.⁷³

Informed by these observations, this Article's question can be restated more precisely: *should regulators require nonderivative financial contracts that have at least one systemically important counterparty to be centrally cleared in order*

a trust and converted into mortgage-backed securities, the underlying promissory notes serve as financial instruments generating a potential income stream for investors"). Normally, derivatives have nothing to do with MBS. See, e.g., FIRST EMPIRE SEC., MORTGAGE BACKED SECURITIES 4, <http://www.1empire.com/Forms/MBS.pdf> [<https://perma.cc/63SV-M8FR>] (stating that "it is important to understand the MBSs are not mortgage derivative investments").

⁶⁶ See Laurence Ball, *The Fed and Lehman Brothers: Introduction and Summary* 7-8 (Nat'l Bureau of Econ. Research, Working Paper No. 22410, 2016), <https://www.nber.org/papers/w22410> [<https://perma.cc/VCA6-AZS7>] (observing that collateral calls by counterparties, including demands for collateral from JP Morgan Chase, the clearing bank for Lehman's tri-party repos, contributed to Lehman's collapse); cf. *infra* note 82 and accompanying text (discussing how the fear of counterparty risk could lead to a systemically important firm's failure).

⁶⁷ Cf. McCracken, *supra* note 34 (explaining why Lehman's derivatives problems resulted from its bankruptcy).

⁶⁸ See *supra* note 28 and accompanying text.

⁶⁹ See *supra* note 32 and accompanying text.

⁷⁰ See, e.g., Gary Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo*, 104 J. FIN. ECON. 425, 425 (2012).

⁷¹ See, e.g., 1. *What Is a Repo?*, INT'L CAPITAL MKT. ASS'N, <https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/repo-and-collateral-markets/icma-ercc-publications/frequently-asked-questions-on-repo/1-what-is-a-repo> [<https://perma.cc/VHQ7-U4UY>].

⁷² See U.C.C. § 1-201(35) (AM. LAW INST. & UNIF. LAW COMM'N 1977) (observing that the "retention or reservation of title by a seller of goods [i.e., a conditional sale agreement] is limited in effect to a reservation of a 'security interest'").

⁷³ See, e.g., Paolo Saguato, *The Liquidity Dilemma and the Repo Market: A Two-Step Policy Option to Address the Regulatory Void*, 22 STAN. J.L. BUS. & FIN. 85, 126 (2017) (arguing that CCPs should be used to reduce risk in the repo markets). Repo dealers already voluntarily engage in a form of central clearing. See *infra* notes 177-79 and accompanying text.

to reduce systemic risk?⁷⁴ Consistent with this restatement, further references in this Article to nonderivative financial contracts shall mean only such contracts that have at least one systemically important counterparty.⁷⁵

The restated question can also be reformulated as an initial theory⁷⁶: to reduce systemic risk, regulators should require central clearing of nonderivative financial contracts that have at least one systemically important counterparty. That theory is incomplete, however, because financial regulation is justified only if its benefits exceed its costs.⁷⁷ Although requiring central clearing of nonderivative financial contracts will create benefits by reducing systemic risk resulting from individual counterparty risk, it can also create costs, notably the transaction costs of creating and operating the CCPs and

74 This Article does not need to differentiate at the outset whether the systemically important counterparty is an obligor or an obligee. Using the preceding example of a loan agreement, *see supra* notes 21–22 and accompanying text, if the systemically important counterparty is a lender (an obligee), the failure of the borrower (an obligor) to repay the loan may cause the lender's failure; whereas if the systemically important counterparty is a borrower (an obligor), its repayment exposure might cause its failure especially if that exposure is aggregated on multiple loans—such as might occur for a highly leveraged firm. *Cf. supra* note 29 and accompanying text (discussing AIG's precrisis aggregated counterparty exposure on CDS contracts).

75 Because derivatives markets are relatively concentrated, *see* Schwarcz, *supra* note 32, at 706, a derivatives contract may be more likely than a nonderivative financial contract to have not just one but two systemically important counterparties. If systemic riskiness were to turn on the contract having at least two systemically important counterparties, this Article's analysis of expanding central clearing to nonderivative financial contracts should be limited to financial contracts that have at least two such counterparties. Analytically though, a financial contract that has just one systemically important counterparty can be systemically risky. Indeed, a financial contract that has two parties, both of whom are systemically important, may be less systemically risky than a financial contract that has just one systemically important counterparty. Both parties to the former contract, being systemically important, would be legally required to maintain capital and other protections that minimize their likely failure. Therefore, neither would likely default under the contract. The nonsystemically important counterparty to the latter contract would thus be more likely to default, which could destabilize that contract's systemically important counterparty.

76 Again, this Article uses the term “theory” in its fundamental meaning as a set of ideas that help to explain something. *See supra* note 19 and accompanying text (quoting the Oxford American Dictionary's definition of theory as “a set of ideas formulated (by reasoning from known facts) to explain something”).

77 *See, e.g.,* Eric A. Posner & E. Glen Weyl, *Benefit-Cost Paradigms in Financial Regulation*, 43 J. LEGAL STUD. (SPECIAL ISSUE) S1, S3 (2014) (arguing that financial regulation should be subject to cost-benefit analysis); Cass R. Sunstein, *Financial Regulation and Cost-Benefit Analysis*, 124 YALE L.J.F. 263, 263 (2015) (explaining that “[c]ost-benefit analysis is best understood as a way for agencies to ensure that their decisions are informed”); *cf. Cost-Benefit Analysis*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining cost-benefit analysis as “[a]n analytical technique that weighs the costs of a proposed decision”); *Cost-Benefit Analysis (CBA)*, BOUVIER LAW DICTIONARY (Stephen Michael Sheppard ed., Wolters Kluwer Compact ed. 2011) (observing that federal agency cost-benefit analysis for determining whether a new regulation is promulgated “must demonstrate that the benefits to society outweigh the costs that the regulation will impose”).

the possible systemic costs of concentrating counterparty risk in the CCPs.⁷⁸ A complete theory should take into account those benefits and costs.⁷⁹

To help develop this theory, this Article next tests it against current regulation requiring the central clearing of derivatives contracts.

II. CENTRAL CLEARING OF DERIVATIVES CONTRACTS

As discussed, the United States and many other nations now require counterparties to centrally clear most of their derivatives contracts through CCPs.⁸⁰ In principle, this makes sense as a way to reduce systemic risk if, as is often the case, the derivatives contract has at least one systemically important counterparty.⁸¹ Counterparty risk that causes the failure—or even the fear of failure—of systemically important counterparties can trigger

⁷⁸ See, e.g., VIKTORIA BAKLANOVA, OCEAN DALTON & STATHIS TOMPAIDIS, OFFICE OF FIN. RESEARCH, BRIEF SERIES NO. 17-04, BENEFITS AND RISKS OF CENTRAL CLEARING IN THE REPO MARKET 1-5 (2017) (discussing those costs); cf. Ivana Ruffini, *Central Clearing: Risks and Customer Protections*, 39 ECON. PERSP. 90, 97 (2015) (observing that central clearing creates systemic costs by concentrating counterparty risk in the CCPs); *infra* note 91 and accompanying text (same).

⁷⁹ Compare *infra* note 86 and accompanying text (observing the Dodd-Frank Act's mandate that reducing systemic risk is so urgent that regulation reducing that risk should not be conditioned on a cost-benefit analysis), with PAUL ROSE & CHRISTOPHER J. WALKER, THE IMPORTANCE OF COST-BENEFIT ANALYSIS IN FINANCIAL REGULATION 2 (2013), <https://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/CBA-Report-3.10.131.pdf> [<https://perma.cc/LYM9-JH7S>] (arguing, in response to the failure to adequately conduct cost-benefit analysis in financial regulation pursuant to the Dodd-Frank Act, that the history and policies that motivate the use of cost-benefit analysis "generally apply with equal (if not greater) force in the financial regulation context" and that "[f]inancial regulators, especially in the context of Dodd-Frank, can and should ground their rulemaking in robust cost-benefit analysis in order to arrive at more rational decision-making and efficient regulatory action as well as to promote good governance and democratic accountability"). This Article's analysis is normative, so it does not purport to rely on the Dodd-Frank Act's aforesaid mandate. Moreover, federal regulators' decision to backtrack on designating insurer MetLife as a SIFI—after initially imposing that designation under the authority of the Dodd-Frank Act—mounted an implied challenge to that law's mandate. See, e.g., John Heltman, *FSOC Gives Up Effort to Designate MetLife as SIFI*, AM. BANKER (Jan. 18, 2018, 9:45 PM EST), <https://www.americanbanker.com/news/fsoc-gives-up-effort-to-designate-metlife-as-sifi>.

⁸⁰ See *supra* notes 28–38 and accompanying text (explaining also that this central clearing requirement is largely a response to the financial crisis, in which counterparty risk in derivatives contracts played out in dramatic fashion).

⁸¹ Adam J. Levitin, *Response: The Tenuous Case for Derivatives Clearinghouses*, 101 GEO. L.J. 445, 452–53 (2013). CCPs may also add value as central information aggregators. Cf. R.A. Washington, *Derivatives: What Is a Clearinghouse?*, ECONOMIST (Apr. 22, 2010), <http://www.economist.com/blogs/freeexchange/2010/04/derivatives> [<https://perma.cc/A6VU-ZZTN>] (explaining that "[c]learinghouses also centralize trade reporting, and can provide any level of post-trade transparency to the OTC derivatives markets that your heart desires—same-day trade reporting, including prices, aggregate and counterparty-level position data, etc." (internal quotation marks omitted) (quoting Economics of Contempt, *Exchanges vs. Clearinghouses (This is Important)*, ECON. OF CONTEMPT (Apr. 14, 2010, 4:36 PM), <http://economicsofcontempt.blogspot.com/2010/04/exchanges-vs-clearinghouses-this-is.html> [<https://perma.cc/W8ZN-Z5SY>])). This role arguably gives CCPs the capacity to create derivatives markets that are less opaque than traditional over-the-counter derivatives markets. Levitin, *supra*, at 451–52.

systemic risk.⁸² By protecting systemically important counterparties from counterparty risk, central clearing can remove that trigger.⁸³

As indicated, however, financial regulation is justified only if its benefits exceed its costs.⁸⁴ The current regulation requiring the central clearing of derivatives contracts does not appear to be justified by any formal cost–benefit analyses.⁸⁵ At least in the United States, that may well reflect the Dodd-Frank Act’s mandate that reducing systemic risk is so important that regulation reducing that risk should not be conditioned on a traditional cost–benefit analysis.⁸⁶

⁸² Cf. DUFFIE, LI & LUBKE, *supra* note 58, at 5 (observing that “[s]ystemic risk also arises when the fear of . . . failure could lead counterparties to attempt to avoid potential losses by reducing their exposures to a large, weak market participant, possibly contributing to a ‘run’ that indeed accelerates the failure of that market participant”); *supra* note 66 and accompanying text (discussing how fear of contracting with Lehman Brothers similarly led to its failure).

⁸³ Absent central counterparty clearing, for example, a concentration of counterparty exposure on a CDS protection seller (for an explanation of CDS protection, see *supra* note 29 and accompanying text) could cause the seller’s failure. If the protection seller is systemically important, its failure in turn could potentially trigger a broader systemic economic collapse. The protection seller’s failure could cause that collapse not merely by virtue of its inability to pay its general obligations but also by virtue of its inability to pay its guarantee obligations on the CDS contracts. This was the very fear that prompted the government to bail out AIG, the protection seller on multiple CDS contracts guaranteeing repayment on mortgage-backed securities. See *supra* note 33 and accompanying text.

⁸⁴ See *supra* notes 77–79 and accompanying text.

⁸⁵ In its “primer” discussing central clearing of OTC derivatives, the International Monetary Fund (IMF) merely stated without formal cost–benefit analysis that “ultimately the benefits of systemic risk reduction from moving OTC derivatives to a CCP very likely outweigh the costs in the longer run.” IMF, *Meeting New Challenges to Stability and Building a Safer System—Making Over-the-Counter Derivatives Safer: The Role of Central Counterparties* 26, Global Financial Stability Report (Apr. 2010). When the European Commission mandated central clearing of standardized OTC derivatives by amending the European Market Infrastructure Regulation (EMIR), it pointed to “commitment[s]” by G20 leaders in 2009 and 2010 to centrally clear these derivatives; but no cost–benefit analysis appears to have justified those commitments. See Council Regulation 648/2012, 2012 O.J. (L 201) 1 (EU). But cf. *Questions and Answers on the Proposal to Amend the European Market Infrastructure Regulation (EMIR)*, EUROPEAN COMM’N (June 13, 2017), http://europa.eu/rapid/press-release_MEMO-17-1583_en.htm [<https://perma.cc/9ER6-4AUC>] (noting that the European Commission “is making its proposal [to require standardized OTC derivatives contracts to be cleared through a CCP] based on feedback that builds on an extensive assessment of EMIR and two public consultations” and that “[t]he main beneficiaries of this proposal are citizens and the economy as a whole through a safer financial system where the probability of the failure of a CCP and the contagion to the broader financial system is further reduced,” thereby suggesting but not confirming the use of cost–benefit analysis).

⁸⁶ The Federal Reserve Board, for example, interprets the Dodd-Frank Act as directing the Federal Reserve, when regulating to mitigate risks to the financial stability of the country, to bypass consideration of costs and benefits. See, e.g., BD. OF GOVERNORS OF THE FED. RESERVE SYS., *CALIBRATING THE GSIB SURCHARGE* 13 (2015), <https://www.federalreserve.gov/aboutthefed/boardmeetings/gsib-methodology-paper-20150720.pdf> [<https://perma.cc/3K5B-LX6A>] (stating that “cost-benefit analysis was not chosen as the primary calibration framework for the GSIB surcharge for two reasons [of which the first is that] it is not directly related to the mandate provided by the Dodd-Frank Act, which instructs the Board to mitigate risks to the financial stability of the United States”); cf. Posner & Weyl, *supra* note 77, at S3 (observing that because U.S. financial regulatory agencies are so-called independent agencies, they have not regarded themselves as bound by executive orders requiring the use of cost–benefit analysis). Professors Posner and Weyl also discuss

Implicitly, however, regulators have made certain cost–benefit judgments. The costs of central clearing include the transaction costs of creating and operating the CCPs and also, ironically, systemic costs resulting from concentrating counterparty risk in the CCPs.⁸⁷ Some scholars argue that requiring central clearing does not even reduce but merely shifts counterparty—and thus systemic—risk from individual counterparties to the CCPs.⁸⁸ Regulators have partly limited the transaction costs by restricting the central clearing requirement to standardized derivatives contracts.⁸⁹ They also recognize the systemic costs.⁹⁰ One Federal Reserve expert warns that the “concentration of risk in CCPs must not be underestimated, as CCP failures, while rare, do happen.”⁹¹ Regulators nonetheless appear to believe, without actually testing, that requiring central clearing of derivatives contracts reduces overall systemic risk notwithstanding CCP counterparty-risk concentration.⁹² At

the importance of reducing systemic risk given that historical data suggest the cost of a systemic crisis can be as high as twenty percent of gross domestic product (GDP). Eric Posner & E. Glen Weyl, *Benefit-Cost Analysis for Financial Regulation*, 103 AM. ECON. REV. 393, 394 (2013).

⁸⁷ To a lesser extent, central clearing can also create costs that arguably are systemic by imposing increased and more rigorous margin requirements, which can create significant liquidity funding needs. Diana Milanesi, *Risk/Benefit Analysis of Central Clearing of Over-the-Counter (OTC) Derivatives and a Chaos Theory-Based Perspective on Clearing Mandates* 197 (Summer 2017) (unpublished Ph.D. dissertation, University of California, Berkeley) (available at <https://cloudfront.escholarship.org/dist/prd/content/qt8nz4n9z9/qt8nz4n9z9.pdf?t=p2rjix>); see also CRAIG PIRRONG, CATO INST., *THE INEFFICIENCY OF CLEARING MANDATES* 3 (2010), <https://object.cato.org/sites/cato.org/files/pubs/pdf/PA665.pdf> [<https://perma.cc/3CEZ-UDKH>] (“Clearinghouses can control moral hazard by imposing margin requirements and limits on the amount of insurance provided. Since collateral is socially costly, however, it is socially costly to control moral hazard this way.”). To mitigate these costs, CCPs now accept a wide range of assets as collateral, subject to appropriate haircuts and, sometimes, hard dollar limits for each class of assets. See, e.g., *Financial and Collateral Management*, CME GRP., <https://www.cmegroup.com/clearing/financial-and-collateral-management.html> [<https://perma.cc/A7PS-R3QN>] (indicating this CCP “accept[s] a diverse portfolio of assets as collateral” subject to those limitations); cf. Derivatives Clearing Organization General Provisions and Core Principles, 76 Fed. Reg. 69,334, 69,346, 69,349–50 (Nov. 8, 2011) (to be codified at 17 C.F.R. pts. 1, 21, 39, 140) (giving CCPs discretion to choose among a wide range of assets to use as margin, provided they apply an appropriate haircut depending on risk).

⁸⁸ See *infra* note 147 and accompanying text.

⁸⁹ See *infra* notes 130–32 and accompanying text (explaining why restricting central clearing to standardized financial contracts should reduce transaction costs).

⁹⁰ See, e.g., Benoît Coeuré, Member, Executive Bd. of the European Central Bank, Lecture at the Federal Reserve Bank of Chicago 2015 Symposium on Central Clearing: Ensuring an Adequate Loss-Absorbing Capacity of Central Counterparties (Apr. 10, 2015) (transcript available at <https://www.ecb.europa.eu/press/key/date/2015/html/sp150411.en.html> [<https://perma.cc/DW2R-8NTU>]); Jerome H. Powell, Member, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Federal Reserve Bank of Chicago Symposium on Central Clearing: Central Clearing and Liquidity (June 23, 2017) (transcript available at <https://www.federalreserve.gov/newsevents/speech/files/powell20170623a.pdf> [<https://perma.cc/FH3J-25BD>]).

⁹¹ Ruffini, *supra* note 78, at 97.

⁹² See, e.g., Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm’n, Speech at the SEC Open Meeting (Dec. 15, 2010) (transcript available at <https://www.sec.gov/news/speech/2010/spch121510mls-1.htm>).

least in the United States, that belief may be based in part on the Dodd-Frank Act's protection of certain CCPs as financial market utilities.⁹³

This Article does not engage the debate on whether requiring central clearing of derivatives contracts reduces, or merely shifts, overall systemic risk. The widespread reality of that central clearing requirement indicates that it may well reduce overall systemic risk. This Article builds on that reality to analyze whether regulators should also require central clearing of nonderivative financial contracts. This approach follows the strong scholarly precedent for grafting a normative legal inquiry onto positive-law reality.⁹⁴ In other words, this Article does not necessarily agree on the merits of the positive-law reality; it merely uses it as an analytical starting point.

As informed by this Part II, this Article's theory can be further restated as follows: To reduce systemic risk, regulation should require central clearing of nonderivative financial contracts that have at least one systemically important counterparty if the benefits of that clearing exceed its costs. To reduce costs, the regulation should (as with central clearing of derivatives contracts) restrict that central clearing to standardized financial contracts and protect the central-clearing CCPs against the systemic costs of concentrated counterparty risk. Pragmatically, central clearing should be further limited to only "material" contracts that have a minimum potential payment obligation.⁹⁵ Appendix 1 of this Article illustrates how such nonderivative financial contracts could be centrally cleared. It also compares that to the central clearing of derivatives contracts. Appendix 2 of this Article explains how to standardize nonderivative financial contracts.

Part III next examines the regulatory and economic efficiency implications of the restated theory.

[<https://perma.cc/DRY9-P34E>]) ("When structured and operated appropriately, clearing agencies provide important benefits like improving the management of counterparty risk [resulting from derivatives] and reducing outstanding exposures through multilateral netting of trades. Through these actions, the 'clearing' process can help to reduce risks to the financial system overall.").

⁹³ See *infra* Section IV.A.

⁹⁴ See, e.g., Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 776-77 (1988) (grafting a normative analysis of bankruptcy law (what should be the best method for dividing the corporate reorganization pie) onto a positive assumption about that law (taking as given the widespread use of the corporate reorganization alternative to liquidation)).

⁹⁵ The minimum should be based on the amount of defaulted payment that could reasonably destabilize a systemically important counterparty. Although setting the minimum would be a regulatory judgment, the author anticipates it would exceed, and might far exceed, ten million dollars.

III. CENTRAL CLEARING OF NONDERIVATIVE FINANCIAL CONTRACTS

Reducing systemic risk is an important regulatory goal.⁹⁶ Central clearing of nonderivative financial contracts can, in principle, significantly reduce that risk.⁹⁷ Therefore, regulation should require that central clearing⁹⁸ if the sum of its anticipated benefits outweighs, or otherwise justifies, the sum of its anticipated costs.⁹⁹ This cost–benefit balancing also follows Kaldor–Hicks efficiency, the practical standard used by economists to assess the economic desirability of a project.¹⁰⁰ A project is Kaldor–Hicks efficient if its overall benefits exceed its overall costs, regardless of who bears the costs and who gets the benefits.¹⁰¹

Section III.A next estimates the anticipated benefits, and Section III.B then estimates the anticipated costs, of centrally clearing nonderivative financial contracts. Section III.C thereafter balances those benefits and costs. Per the restated theory, these estimates of benefits and costs are restricted to central clearing of standardized material nonderivative financial contracts that have at least one systemically important counterparty. The estimates also assume that CCPs used for that central clearing will be protected against concentrated counterparty risk the same way that CCPs used for central clearing of derivatives contracts are protected.

This Article does not, however, attempt to quantify all of the benefits and costs of centrally clearing nonderivative financial contracts. Instead, its cost–benefit balancing starts by taking as given that the benefits of centrally clearing *derivatives*

⁹⁶ Cf. *supra* notes 85–86 and accompanying text (observing the regulatory importance of reducing systemic risk).

⁹⁷ Parts I and II of this Article have shown that nonderivative financial contracts can be systemically risky, that the aggregate net counterparty exposure on those contracts greatly exceeds that on derivatives contracts, and that central clearing of those contracts can reduce systemic risk the same way that it reduces systemic risk for derivatives contracts.

⁹⁸ This logic follows a consequence-based-inquiry (CBI) normative framework to determine when financial market changes should drive legal changes. See generally Steven L. Schwarcz, *Changing Law to Address Changing Markets: A Consequence-Based Inquiry*, 80 LAW & CONTEMP. PROBS., no. 1, 2017, at 163.

⁹⁹ See *supra* note 77; cf. MAEVE P. CAREY, CONG. RESEARCH SERV., R41974, COST-BENEFIT AND OTHER ANALYSIS REQUIREMENTS IN THE RULEMAKING PROCESS 1 (2014) (observing that a “proposed regulatory requirement is judged to pass the ‘cost-benefit test’ if the sum of its anticipated benefits outweighs, or otherwise justifies, the sum of its present and future costs in present value terms” and explaining that “[c]ost-benefit analysis, in [the federal rulemaking] context, involves the systematic identification of all of the costs and benefits associated with a forthcoming regulation”); WILLIAM F. FOX, UNDERSTANDING ADMINISTRATIVE LAW 187 (6th ed. 2012) (stating that each of “the different processes of analysis that sometimes fit[s] under the general umbrella of cost-benefit analysis . . . is an attempt to . . . get as much information and insight on a *proposed government action* as possible” (emphasis added)).

¹⁰⁰ ROBIN PAUL MALLOY, LAW IN A MARKET CONTEXT: AN INTRODUCTION TO MARKET CONCEPTS IN LEGAL REASONING 190 (2004).

¹⁰¹ *Id.*

contracts exceeds its costs.¹⁰² From that starting point, the cost–benefit balancing of centrally clearing nonderivative financial contracts turns on how those benefits and costs vary from those of central clearing derivatives contracts. If, for example, the benefits of centrally clearing nonderivative financial contracts are at least—and the costs of centrally clearing nonderivative financial contracts do not exceed—the respective benefits and costs of centrally clearing derivatives contracts, then central clearing of nonderivative financial contracts should satisfy a cost–benefit balancing.

A. *Estimating the Benefits of Centrally Clearing
Nonderivative Financial Contracts*

The primary benefit of centrally clearing nonderivative financial contracts—just like that of centrally clearing derivatives contracts—would be the reduction of systemic risk at the level of individual systemically important counterparties.¹⁰³ Although the benefit of that risk reduction has not been estimated for centrally clearing derivatives contracts, it is almost certainly huge. The cost of the financial crisis has been estimated as exceeding twenty-two trillion dollars.¹⁰⁴ If it reduces the risk of another financial collapse by even ten percent, centrally clearing derivatives contracts could save hundreds of billions of dollars, if not more.

Centrally clearing nonderivative financial contracts could reduce systemic risk by an amount roughly comparable to (and possibly more than) the reduction achieved by centrally clearing derivatives contracts. As previously explained, the aggregate counterparty exposure on nonderivative financial contracts greatly exceeds that on derivatives contracts.¹⁰⁵ The aggregate

¹⁰² Cf. *supra* notes 85–94 and accompanying text (observing that regulators assume, without actually testing, that central clearing of derivatives contracts reduces overall systemic costs, and stating that because central clearing of derivatives contracts is so widespread, this Article takes that regulatory assumption as a starting point for analysis).

¹⁰³ See *supra* note 10 and accompanying text. This cost–benefit analysis does not attempt to predict possible ways in which innovative new technologies, such as blockchain and distributed ledger technology (DLT), might change bilateral clearing of financial contracts to reduce systemic risk. Diana Milanese has been considering such possibilities and whether new technologies might ultimately replace or supplement the need for central clearing. See Milanese, *supra* note 87, at 164–65.

¹⁰⁴ Eleazar David Melendez, *Financial Crisis Cost Tops \$22 Trillion, GAO Says*, HUFFINGTON POST (Feb. 14, 2013, 7:49 PM ET), https://www.huffingtonpost.com/2013/02/14/financial-crisis-cost-gao_n_2687553.html [<https://perma.cc/GE7K-RXXF>]; cf. FED. RESERVE BANK OF MINNEAPOLIS, THE MINNEAPOLIS PLAN TO END TOO BIG TO FAIL 60 (2016), <https://www.minneapolisfed.org/-/media/files/publications/studies/endingtbtf/the-minneapolis-plan/the-minneapolis-plan-to-end-too-big-to-fail-final.pdf?la=en> [<https://perma.cc/829M-EJ68>] (observing that as a result of the financial crisis, “trillions of dollars in American wealth was destroyed”).

¹⁰⁵ See *supra* notes 13–14 and accompanying text. The news media sometimes incorrectly suggest that the opposite is true, referencing the “notional amount” of derivatives outstanding globally (which is almost ten times as large as world GDP). See, e.g., *\$700 Trillion in Global OTC Derivatives? Behind*

counterparty exposure on the set of nonderivative financial contracts on which this Article focuses (those with systemically important counterparties and that are standardized¹⁰⁶) might, or might not, also exceed the aggregate counterparty exposure on the set of derivatives contracts that are required to be centrally cleared (those that are standardized).¹⁰⁷ Assume, conservatively, that the exposures are merely comparable. Because those nonderivative financial contracts can be as systemically risky as derivatives contracts, central clearing of those contracts should reduce systemic costs by an order of magnitude corresponding to the hundreds-of-billions-of-dollars cost reduction achieved by centrally clearing derivatives contracts.¹⁰⁸

The foregoing comparison of systemic cost reduction implicitly presumes that central clearing would reduce systemic risk for nonderivative financial contracts as effectively as it would reduce systemic risk for derivatives contracts. Some might argue, however, that central clearing would reduce systemic risk more effectively for derivatives contracts, which are more susceptible to multilateral netting.¹⁰⁹ Multilateral netting refers to a CCP's ability to net offsetting payment obligations among its clearing members¹¹⁰: "Multilateral netting allows for the aggregate offset of positions and the termination of economically redundant obligations. Multilateral netting offsets obligations [among] multiple parties as opposed to bilateral netting, which offsets obligations between only two counterparties."¹¹¹

the Number, MILKEN INST.: BLOG (Mar. 31, 2014), <http://www.milkeninstitute.org/blog/view/580> [<https://perma.cc/QF87-DP4P>] (discussing the news media's mistaken reliance on notional amount to measure the size of the derivatives market). The notional amount does not reflect the amount at risk on a derivative; it merely refers to the value of underlying assets specified in the derivatives contract. See, e.g., APANARD PRABHA, KEITH SAVARD & HEATHER WICKRAMARACHI, MILKEN INST., DERIVING THE ECONOMIC IMPACT OF DERIVATIVES 27 (2014), <http://assets1b.milkeninstitute.org/assets/Publication/ResearchReport/PDF/Derivatives-Report.pdf> [<https://perma.cc/5CKQ-ANDS>] ("[N]otional amounts outstanding, though a rough measure of derivatives activity, do not represent . . . generally, the amount at risk." (citations omitted)). The more appropriate measure of risk exposure—which this Article uses as a basis for comparison—is gross market value. See MONETARY & ECON. DEP'T, *supra* note 14, at 2 (explaining that "gross market value represents the maximum loss that market participants would incur if all counterparties failed to meet their contractual payments and the contracts could be replaced at current market prices").

¹⁰⁶ See *supra* text following note 101.

¹⁰⁷ See *supra* Section I.B.

¹⁰⁸ See *supra* notes 103–04 and accompanying text; cf. BAKLANOVA, DALTON & TOMPAIDIS, *supra* note 78, at 6 (estimating the benefits of expanding the central clearing of repo transactions beyond dealers as including—merely for that one type of nonderivative financial contract—a \$53.7 billion reduction in net exposure).

¹⁰⁹ Two reviewers of this Article made that argument.

¹¹⁰ For an explanation of CCP clearing members and their responsibilities, see *infra* notes 162–67 and accompanying text.

¹¹¹ Ruffini, *supra* note 78, at 91 (emphasis omitted).

The distinction between bilateral and multilateral netting arises from basic setoff law. Parties generally have the right to set off, or “net,” mutually offsetting matured obligations.¹¹² For example, if Party *A* owes \$1,000,000 to Party *B* and Party *B* owes \$250,000 to Party *A*, then Party *A* owes only \$750,000 to Party *B* on a net basis after setoff.¹¹³ Bilateral setoff refers to this type of ordinary setoff between two parties.

In contrast, multilateral netting refers to setoff among multiple parties. Setoff law does not normally permit multilateral netting because setoff rights require precise mutuality of obligations.¹¹⁴ Central clearing, however, creates the equivalent of mutuality by virtue of novation—in which the CCP legally substitutes its credit for that of the contracting parties, making it the primary counterparty on both sides of the contract.¹¹⁵ Thus, if clearing member *A* owes clearing member *B* \$1,000,000 and clearing member *B* owes clearing member *C* \$1,000,000, clearing member *B*’s offsetting obligations will be set off (i.e., netted) and clearing member *A* will simply owe clearing member *C* the \$1,000,000.

The argument that central clearing would reduce systemic risk more effectively for derivatives contracts than for nonderivative financial contracts depends, in the first instance, on the former being more susceptible to multilateral netting.¹¹⁶ Derivatives contracts are indeed likely to be more susceptible to multilateral netting because relatively more counterparties on derivatives contracts would be CCP clearing members.¹¹⁷ That reflects the current reality that derivatives-contract counterparties tend to be highly concentrated.¹¹⁸

Ultimately, however, the argument that central clearing would reduce systemic risk more effectively for derivatives contracts than for nonderivative financial contracts assumes that multilateral netting reduces systemic risk.¹¹⁹ The

¹¹² Stephen L. Sepinuck, *The Problems with Setoff: A Proposed Legislative Solution*, 30 WM. & MARY L. REV. 51, 54 (1988).

¹¹³ Used as a noun, the term is a “setoff”; used as a verb, the expression is to “set off.”

¹¹⁴ See, e.g., *Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 18 (1995) (“The right of setoff . . . allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding ‘the absurdity of making A pay B when B owes A.’” (quoting *Studley v. Boylston Nat’l Bank*, 229 U.S. 523, 528 (1913))); *Mintz v. Tri-County Nat. Gas Co.*, 103 A. 285, 286 (Pa. 1918) (“Mutuality of debts is the essential circumstance of a set-off.” (internal quotation marks omitted)).

¹¹⁵ See *supra* note 6 and accompanying text.

¹¹⁶ See *supra* note 109 and accompanying text.

¹¹⁷ See *infra* notes 175–77 and accompanying text.

¹¹⁸ See, e.g., Schwarcz, *supra* note 32, at 706 (discussing the concentration of derivatives markets). Most of the Options Clearing Corporation’s clearing members, for example, are well-known financial institutions like Deutsche Bank Securities Inc., Goldman Sachs & Co., Wells Fargo Securities, LLC, and Citigroup Global Markets Inc. See OPTIONS CLEARING CORP., 2016 ANNUAL REPORT 47 (2017), <https://www.theocc.com/components/docs/about/annual-reports/occ-2016-annual-report.pdf> [<https://perma.cc/KK2Q-VBGR>].

¹¹⁹ Cf. IMF, *supra* note 85, at 6 (stating that “[m]ultilateral compression and tear-up operations eliminate redundant contracts and reduce counterparty risk, and shorten and simplify systemic

accuracy of that assumption has not been rigorously tested. Some question that assumption, arguing that while multilateral netting can reduce credit risk, it can increase systemic risk.¹²⁰ Professor Mokal further contends that multilateral netting encourages greater leverage and thus greater risk, redistributes risk rather than diminishes it, weakens lending standards by worsening financial agency and adverse selection costs, increases market volatility because net exposures are vulnerable to movements that are multiples of the changes in the underlying obligations, and spreads the effects of a systemic shock.¹²¹ For the reasons discussed in Appendix 1, the author also personally questions whether multilateral netting reduces systemic risk.¹²²

This Article does not attempt, however to definitively resolve whether multilateral netting reduces systemic risk.¹²³ If multilateral netting does not reduce that risk, the benefits of centrally clearing nonderivative financial contracts would closely resemble the benefits of centrally clearing derivatives contracts. Central clearing of nonderivative financial contracts would then more clearly satisfy a cost–benefit balancing.

Centrally clearing nonderivative financial contracts could also provide benefits beyond reducing systemic risk. For example,¹²⁴ it could reduce transaction costs by enabling CCPs to net offsetting contractual obligations, thereby more efficiently managing counterparty risk.¹²⁵ It could also provide an indirect political benefit: by shifting counterparty risk from numerous systemically important counterparties to a limited number of CCPs, it would facilitate the so-called

interconnections”); Ruffini, *supra* note 78, at 91 (stating that “multilateral netting of obligations[] often result[s] in a reduction of counterparty credit risk and the liquidity risk borne by” clearing members).

¹²⁰ See, e.g., BANK FOR INT’L SETTLEMENTS, REPORT OF THE COMMITTEE ON INTERBANK NETTING SCHEMES OF THE CENTRAL BANKS OF THE GROUP OF TEN COUNTRIES 7 (1990), <https://www.bis.org/cpmi/publ/do4.pdf> [<https://perma.cc/3CSN-26KM>].

¹²¹ Mokal, *supra* note 56, at 19, 60–62.

¹²² See *infra* Appendix 1.

¹²³ Multilateral netting more clearly increases CCP operational efficiencies. Cf. Froukelien Wendt, *Central Counterparties: Addressing Their Too Important to Fail Nature* 4 (Int’l Monetary Fund, Working Paper No. WP/15/21, 2015), <https://www.imf.org/external/pubs/ft/wp/2015/wp1521.pdf> [<https://perma.cc/JW9E-XKL2>] (observing that “multilateral netting . . . reduc[es] the total credit exposure in the market as well as the number of transactions that need to be settled, which results in operational efficiencies” (footnote omitted)).

¹²⁴ Another possible benefit of centrally clearing nonderivative financial contracts is that it might increase transparency. Cf. John Hull, *OTC Derivatives and Central Clearing: Can All Transactions Be Cleared?*, FIN. STABILITY REV., July 2010, at 71, 76 (arguing that a benefit of centrally clearing nonstandard derivatives contracts would be increasing transparency).

¹²⁵ See, e.g., Cyril Monnet, *Let’s Make It Clear: How Central Counterparties Save(d) the Day*, BUS. REV., Q1 2010, at 1, 5 (“[T]he CCP works best if contracts are completely standardized . . . [N]etting is limited if contracts are only imperfectly substitutable.”); cf. Mokal, *supra* note 56, at 58–59 (observing that netting allows CCP members to collateralize only their net rather than gross exposures (enabling members to stretch collateral to cover a greater volume of transactions), enables a more efficient use of regulatory capital, and enhances liquidity by allowing flexibility across legal categories and asset types).

single-point-of-entry (SPOE) resolution strategy currently pursued by regulators. This strategy is artificially dependent, among other things, on government receivership and operation of a troubled systemically important firm.¹²⁶ Concentrating risk in CCPs could reduce the number of government receiverships that are needed under that strategy—a benefit that could help to offset the potential moral hazard cost of that risk concentration.¹²⁷

B. *Estimating the Costs of Centrally Clearing Nonderivative Financial Contracts*

Although the benefits of centrally clearing nonderivative financial contracts could be huge, such clearing would generate at least two types of costs: the transaction costs of creating and operating the CCPs, and the possible systemic costs of concentrating counterparty risk in the CCPs.¹²⁸ Consider each in turn.

1. Transaction Costs

The transaction costs of creating and operating CCPs for centrally clearing nonderivative financial contracts would not appear to be very different from the transaction costs of existing CCPs. An existing CCP whose clearing members include the relevant counterparties could even clear both types of contracts.

A possible difference in operating costs might result from nonderivative financial contracts being less standardized than derivative contracts. Standardization reduces transaction costs because CCPs can much more easily net offsetting obligations on standardized contracts than on nonstandardized contracts.¹²⁹ This cost differential might become insignificant, however, because nonderivative financial contracts increasingly are being documented on a standardized basis, like derivative contracts.¹³⁰ Indeed, many

¹²⁶ John Crawford, “Single Point of Entry”: *The Promise and Limits of the Latest Cure for Bailouts*, 109 NW. U. L. REV. ONLINE 103, 107 (2014).

¹²⁷ Cf. *infra* notes 145–53 and accompanying text (discussing the too big to fail problem).

¹²⁸ See *supra* note 78 and accompanying text.

¹²⁹ To understand why, consider how netting works. Central clearing practice allows a CCP to net offsetting obligations even if they are between different members of the CCP. For example, a CCP can net the obligation of member X to deliver a security to the CCP against the CCP's concurrent obligation to deliver that same security to member Y. See 27. *What Does a CCP Do? What Are the Pros and Cons?*, INT'L CAPITAL MKTS. ASS'N, <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/repo-and-collateral-markets/frequently-asked-questions-on-repo/27-what-does-a-ccp-do-what-are-the-pros-and-cons> [https://perma.cc/FE2M-MRQK] [hereinafter *What Does a CCP Do?*] (describing the process of netting for CCPs). In contrast, “[n]onstandard contracts cannot be netted, since each one's cash flow characteristics are different.” IMF, *supra* note 85, at 6.

¹³⁰ Another reason the cost differential might be insignificant is that a significant portion of derivatives contracts, referred to as over-the-counter derivatives, are themselves not standardized. Prior to postcrisis financial regulation, most derivatives were OTC. Levitin, *supra* note 81, at 449. Even after the financial crisis, the notional amount of OTC derivatives has been estimated as \$693

nonderivative financial contracts are being documented on standard form contracts developed by the International Swaps and Derivatives Association (ISDA) for documenting derivatives transactions. This is being done to gain the advantage of bankruptcy law's "safe harbor" exemptions for derivatives contracts.¹³¹ Loan agreements and virtually any other type of financial contract can be documented as a derivatives contract.¹³² Some textbooks are even openly encouraging parties to document financing contracts as derivatives contracts in order to take advantage of that safe harbor.¹³³

Any cost differential could also be managed. The laws requiring central clearing of derivatives contracts control transaction costs by limiting such clearing to standardized derivatives contracts.¹³⁴ Any laws requiring central clearing of nonderivative financial contracts could likewise—and this Article has proposed that any such laws should¹³⁵—control transaction costs by limiting such clearing to standardized¹³⁶ nonderivative financial contracts. Appendix 2 of this Article discusses standardized nonderivative financial contracts.

The fact that CCPs are often associated with derivatives and commodities exchanges,¹³⁷ whereas nonderivative financial contracts are less likely to depend on exchanges,¹³⁸ might appear to create another possible transaction-cost

trillion worldwide. MONETARY & ECON. DEP'T, BANK FOR INT'L SETTLEMENTS, STATISTICAL RELEASE OTC DERIVATIVES STATISTICS AT END-JUNE 2013, at 2 (2013), http://www.bis.org/publ/otc_hy1311.pdf [<https://perma.cc/RJ6Z-VBXE>].

¹³¹ Steven L. Schwarcz & Ori Sharon, *The Bankruptcy-Law Safe Harbor for Derivatives: A Path-Dependence Analysis*, 71 WASH. & LEE L. REV. 1715, 1752 (2014).

¹³² *Id.* at 1752.

¹³³ See *id.*; see also Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 91, 121 (2005); Bryan G. Faubus, *Narrowing the Bankruptcy Safe Harbor for Derivatives to Combat Systemic Risk*, 59 DUKE L.J. 801, 828-29 (2010).

¹³⁴ See also HECKINGER, RUFFINI & WELLS, *supra* note 37, at 31 (stating that "[w]hether or not an OTC trade is cleared on a CCP depends on the degree of standardization of contract terms"); IMF, *supra* note 85, at 12 (addressing that "U.S. authorities are proposing legislation that will incentivize, if not mandate, clearing 'eligible' OTC derivatives through CCPs"); *CFTC Reports*, U.S. COMMODITIES FUTURES TRADING COMM'N, <https://www.cftc.gov/About/CFTCReports/index.htm> [<https://perma.cc/Z34H-YRQ4>] ("Standardized derivatives will be required to trade on open platforms and be submitted for clearing to central counterparties . . ."); cf. *supra* text accompanying note 89 (observing that regulators have partly limited transaction costs by restricting central clearing only to standardized derivatives contracts); *supra* notes 130-32 and accompanying text.

¹³⁵ See *supra* text accompanying notes 94-95.

¹³⁶ This Article does not examine whether nonstandardized financial contracts should be centrally cleared. Cf. Hull, *supra* note 124, at 74-75 (advocating that all derivatives contracts—especially nonstandard OTC contracts, because those are the most likely to be used for large speculative positions that can increase systemic risk—be centrally cleared). Hull argues that the difficulties of centrally clearing nonstandard derivatives contracts would be outweighed by the benefits, which include reducing counterparty risk and increasing transparency. See *id.* at 76-77. He also says that nonstandard contracts could be netted if they could be valued daily. *Id.*

¹³⁷ See *supra* note 5 and accompanying text.

¹³⁸ A loan agreement, for example, is rarely traded on an exchange.

differential.¹³⁹ In recent years however, many CCPs have decoupled their exchange affiliation and started operating as independent companies.¹⁴⁰ This suggests that their profitability, which is dependent on controlling transaction costs, is not necessarily tied to particular exchanges.

2. Systemic Costs

The primary costs of centrally clearing nonderivative financial contracts would be, paradoxically, potentially increasing systemic costs: by concentrating counterparty risk in CCPs, central clearing makes the CCPs even more systemically important than the original counterparties.¹⁴¹ In other words, central clearing would reduce the systemic costs of individual systemically important counterparties but increase the systemic costs of CCPs. The question is whether it reduces the *overall* systemic costs.

Even in the derivatives context, there is controversy whether central clearing reduces overall systemic costs.¹⁴² Regulators assume, however, that it does reduce those overall costs.¹⁴³ This subsection's focus is therefore on whether central clearing of nonderivative financial contracts would change that overall systemic cost balance.

Central clearing of nonderivative financial contracts would reduce the systemic costs of individual systemically important counterparties the same way—by having CCPs assume the counterparty risk—that central clearing of derivatives contracts reduces those systemic costs. Therefore, if those CCPs are protected against risk concentration at least as well as CCPs that centrally clear derivatives contracts are protected, central clearing of nonderivative financial contracts should not change that overall cost balance.¹⁴⁴ Part IV of this Article explains how those CCPs could be equally well protected.

¹³⁹ No informational or expertise-related transaction-cost differential should result from CCPs clearing nonderivative financial contracts, with which they are not familiar. The clearing members themselves, not the CCP, value the credit risk on the contracts being cleared. *Cf. supra* text accompanying note 117 (discussing counterparties as CCP clearing members).

¹⁴⁰ *See infra* note 163 (observing that many CCPs have now become independent companies).

¹⁴¹ *Cf. What Does a CCP Do?*, *supra* note 129 (describing a drawback of centrally clearing derivatives contracts as “concentrat[ing]” risk in CCPs, “which will themselves become potential sources of systemic risk”). Their size, interconnectedness with clearing members, and lack of substitutability make CCPs highly systemically risky. *Cf. supra* text accompanying note 55 (discussing size, interconnectedness, and substitutability as the three main determinants of systemic risk). Central clearing might also increase the correlation of risks among systemically important firms. The financial crisis intensified when numerous systemically important firms began to fail because of their correlated investments (in MBS).

¹⁴² *See supra* notes 85–93 and accompanying text.

¹⁴³ *See supra* notes 85–93 and accompanying text.

¹⁴⁴ Central clearing of nonderivative financial contracts might even improve the overall cost balance by enabling CCPs to clear a larger number of contracts. *Cf. RODNEY GARRATT & PETER ZIMMERMAN, FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 717, DOES CENTRAL CLEARING*

Centrally clearing nonderivative financial contracts might, however, increase the perception of systemic costs tied to the so-called “too big to fail” (TBTF) problem—that systemically important financial firms might engage in excessive risk taking because they would profit from success and be bailed out by the government to avoid a failure.¹⁴⁵ There is an increasing worldwide regulatory focus on trying to end the TBTF problem.¹⁴⁶

Critics have argued, in the derivatives context, that CCPs are the “ultimate” too big to fail organizations.¹⁴⁷ Because a CCP is “a central node in the financial system,” and thus highly interconnected with other financial institutions,¹⁴⁸ its failure could have effects similar to what was feared could happen if AIG had failed during the financial crisis¹⁴⁹—what has been described as “staring into the abyss.”¹⁵⁰ For example, a CCP’s failure could suspend all or a portion of the market for derivatives transactions, causing systemic contagion including “fire sales of collateral or derivatives contracts, exacerbating broad market volatility.”¹⁵¹ The government would therefore almost certainly have to bail out a failing CCP. And the expectation of a bailout could foster moral hazard, incentivizing CCPs themselves to take greater risks.¹⁵²

REDUCE COUNTERPARTY RISK IN REALISTIC FINANCIAL NETWORKS? 1 (2015) (arguing that a CCP’s netting is unlikely to be valuable when the network relies on only a few key nodes).

¹⁴⁵ This is primarily a problem of moral hazard; persons protected from the negative consequences of their risky actions will be tempted to take more risks. See Steven L. Schwarcz, *Too Big to Fool: Moral Hazard, Bailouts, and Corporate Responsibility*, 102 MINN. L. REV. 761, 761 (2017) (analyzing the TBTF problem and the causes of excessive risk taking).

¹⁴⁶ See *id.* at 762–63 (discussing regulatory efforts by the U.S. Federal Reserve and also by the Financial Stability Board, an organization established by the G20 nations, to monitor and make recommendations about the global financial system).

¹⁴⁷ See, e.g., Iman Anabtawi & Steven L. Schwarcz, *Regulating Systemic Risk: Towards an Analytical Framework*, 86 NOTRE DAME L. REV. 1349, 1394–95 (2011) (observing that centralized clearing of derivatives would shift counterparty risk from individual counterparties to the CCP, thereby concentrating the risk); Mark J. Roe, *Clearinghouse Overconfidence*, 101 CALIF. L. REV. 1641, 1692 n.123 (2013) (collecting sources); Yadav, *supra* note 39, at 387, 391 (challenging the “academic and policy consensus that clearinghouses adequately mitigate the risks of trading credit derivatives”).

¹⁴⁸ Cf. *supra* notes 55–56 and accompanying text (discussing interconnectedness as one of the three systemic risk factors).

¹⁴⁹ See, e.g., Steven McNamara, *Financial Markets Uncertainty and the Rawlsian Argument for Central Counterparty Clearing of OTC Derivatives*, 28 NOTRE DAME J.L. ETHICS & PUB. POL’Y 209, 259 (2014) (“The urge to backstop [a CCP] in the event of a market crisis would be considerable, and governments could then be faced with the ultimate ‘TBTF’ entity.”).

¹⁵⁰ Jeff Kearns & Robert Schmidt, *From Davos to Big Sur, Geithner Recounts Staring into the Abyss*, BLOOMBERG (May 10, 2014, 12:00 AM EDT), <https://www.bloomberg.com/news/articles/2014-05-09/geithner-recounts-standing-at-big-sur-cliff-edge-as-crisis-grew>.

¹⁵¹ See Darrell Duffie, *Resolution of Failing Central Counterparties* (arguing that a CCP’s “fail[ure] to meet its obligations to other systemically [important] clearing members” could cause that contagion), in MAKING FAILURE FEASIBLE: HOW BANKRUPTCY REFORM CAN END “TOO BIG TO FAIL” 87, 88 (Kenneth E. Scott, Thomas H. Jackson & John B. Taylor eds., 2015).

¹⁵² Cf. Levitin, *supra* note 81, at 464 (arguing that, without proper regulation, CCPs may engage in underpriced risk taking, thereby increasing systemic risk).

Qualitatively, any such perception of systemic costs should be no different whether CCPs clear derivatives contracts or nonderivative financial contracts. Quantitatively, however, requiring nonderivative financial contracts to be centrally cleared would add to the volume of CCP clearing, thereby possibly increasing that perception. Such an increased perception would certainly represent a political cost. It unlikely represents an increase in actual systemic costs, however, because there is no real evidence that the TBTF problem increases risk taking.¹⁵³

C. *Balancing Benefits and Costs*

The analysis in Sections III.A and III.B indicates that—other than possible differences in the benefits of multilateral netting—the benefits and the costs of centrally clearing nonderivative financial contracts would roughly parallel those of centrally clearing derivatives contracts. Both types of contracts are standardized financial contracts that have systemically important counterparties.¹⁵⁴ Although centrally clearing nonderivative financial contracts might increase the perception of systemic costs tied to the TBTF problem, any such increase would represent political, not actual, costs and thus should not strictly be included in a cost–benefit balancing.¹⁵⁵ Accordingly, if the benefits of centrally clearing derivatives contracts exceed its costs (which, as discussed, is an untested premise¹⁵⁶), then—again subject to possible differences in the benefits of multilateral netting—the benefits of centrally clearing nonderivative financial contracts might also exceed its costs.

Because its cost–benefit balancing is based on rough approximations, an untested premise, and possible differences in the benefits of multilateral netting, this Article cannot—and does not purport to—conclude that regulation should require central clearing of nonderivative financial contracts. Nonetheless, this Article’s approach to cost–benefit balancing should provide a useful way of thinking about whether regulators should impose that central clearing requirement.¹⁵⁷

¹⁵³ Schwarcz, *supra* note 145, at 764–69.

¹⁵⁴ Derivatives contracts are at least likely to have, and the nonderivative financial contracts analyzed in this Article are limited to those that have, at least one systemically important counterparty.

¹⁵⁵ See C.W., *Why Doing a Cost-Benefit Analysis Is Harder than It Looks*, *ECONOMIST: THE ECONOMIST EXPLAINS* (Apr. 24, 2014), <https://www.economist.com/the-economist-explains/2014/04/23/why-doing-a-cost-benefit-analysis-is-harder-than-it-looks> [<https://perma.cc/3YVT-4XH6>] (“The aim [of a cost–benefit analysis] is to provide an impartial, evidence-based judgment of the costs and benefits of a particular policy or project, *without regard to its political ramifications*.” (emphasis added)).

¹⁵⁶ See *supra* text accompanying note 92. Recall that this Article builds on the widespread reality of the central clearing requirement for derivatives contracts as an indicator that such clearing may well reduce overall systemic risk, without necessarily agreeing whether it reduces that overall risk. See *supra* text accompanying note 94.

¹⁵⁷ Even detailed empirical research by the U.S. Office of Financial Research has not yet provided a more useful way of thinking about the value of requiring central clearing. Cf. BAKLANOVA, DALTON & TOMPAIDIS, *supra* note 78, at 7 (reaching a noncommittal conclusion, itself

In the United States, there may be an additional way to think about the value of requiring central clearing for nonderivative financial contracts. Recall that Congress has viewed systemic risk regulation so important as to exempt it from traditional cost–benefit analysis.¹⁵⁸ If regulation requiring central clearing for nonderivative financial contracts follows that mandate, the only cost–benefit question would be whether the regulation reduces overall systemic costs, i.e., whether its reduction of systemic costs of individual systemically important counterparties outweighs the increase of systemic costs caused by concentrating CCP counterparty risk. By ignoring transaction costs, that affords an even easier cost–benefit balancing in favor of regulation requiring central clearing for nonderivative financial contracts.

IV. ADAPTING AND ENHANCING CENTRAL COUNTERPARTY RISK PROTECTION

The foregoing cost–benefit analysis presupposes that CCPs used for centrally clearing nonderivative financial contracts would be protected against risk concentration at least as well as are CCPs used for centrally clearing derivatives contracts.¹⁵⁹ This Part explains why those CCPs could be equally well protected. To that end, Section IV.A examines how current protections could be adapted to CCPs used to clear nonderivative financial contracts. Thereafter, Section IV.B examines how those protections could be enhanced, which would make central clearing of nonderivative financial contracts even more likely to satisfy a cost–benefit balancing.

A. *Adapting Existing Protections*

All of the current protections against CCP risk concentration either would apply, or could be adapted, to CCPs used to clear nonderivative financial contracts.¹⁶⁰ CCPs currently employ various protections against risk concentration, and thus against the risk of default.¹⁶¹ To minimize these risks,

based on “[s]everal caveats,” as to whether “the potential benefits outweigh the costs” for expanding central clearing of repo transactions to transactions involving nondealers).

¹⁵⁸ See *supra* note 86 and accompanying text.

¹⁵⁹ See *supra* text accompanying note 144.

¹⁶⁰ Although the textual discussion primarily addresses U.S.-based CCPs, the European Union has similar protections against CCP risk concentration. See Bas Zebregs & Victor de Sèrière, *Efforts to Strengthen the Clearing and Settlement Framework of the Capital Markets Union*, in CAPITAL MARKETS UNION IN EUROPE 526, 531–35 (Danny Busch, Emiliós Avgouleas & Guido Ferrarini eds., 2018).

¹⁶¹ See NORMAN, *supra* note 6, at 10 (“Because a CCP represents a single point of failure, it needs to be bullet proof.” (internal quotation marks omitted) (quoting Andrew G. Haldane, Exec. Dir., Bank of Eng., Remarks at Federal Reserve Bank of Chicago 45th Annual Conference “Reforming Financial Regulation”: Small Lessons from a Big Crisis 5 (May 8, 2009) (transcript

CCPs typically grant central clearing services to a relatively small number of firms, normally limited to well-capitalized banks and other large financial institutions that become “clearing members” of the CCP.¹⁶² By becoming clearing members, firms assume various responsibilities that help to support the CCP’s financial integrity.¹⁶³ These include agreeing to maintain sufficient collateral to reimburse the CCP for payment of the clearing member’s individual counterparty obligations,¹⁶⁴ to contribute (on a pro rata basis with the other clearing members) to a loss-absorbency fund that can be used to cover the CCP’s losses in case a clearing member fails to so reimburse the CCP,¹⁶⁵ and to pay capital assessments into the CCP as needed to keep it solvent.¹⁶⁶

available at <https://www.bis.org/review/ro90710e.pdf> [<https://perma.cc/6RS4-GD3F>]); cf. *supra* note 8 and accompanying text (observing that counterparty risk is sometimes called default risk).

¹⁶² See Levitin, *supra* note 81, at 451 (describing the various risk management tools available to CCPs); see also INTERCONTINENTAL EXCH., INC., *MANAGE YOUR RISK: HOW CLEARING WORKS 2* (2016), https://www.theice.com/publicdocs/How_Clearing_Works.pdf [<https://perma.cc/A38C-9Q42>] (“[C]learing houses have in place a comprehensive set of procedures and a robust risk management framework that includes: [r]eal-time position monitoring[, i]ntraday mark to market margining[, s]ubstantial default resources[, r]igorous stress testing[, c]omprehensive oversight[, and e]xtensive transparency.”). Firms other than clearing members can only get access to the derivatives market through clearing members. NORMAN, *supra* note 6, at 10.

¹⁶³ Originally, CCPs were owned by their clearing members, but many CCPs have now demutualized and become part of publicly traded companies. CCPs nonetheless continue to enforce strict membership responsibilities to help support their own financial integrity. Ruffini, *supra* note 78, at 91; cf. Paolo Saguato, *The Ownership of Clearinghouses: When “Skin in the Game” Is Not Enough, the Remutualization of Clearinghouses*, 34 YALE J. ON REG. 601, 635-40 (2017) (assessing the implications of different ownership structures on CCPs’ resilience). These strict membership responsibilities, however, typically limit clearing members to large and often systemically important banks and other firms, thereby linking CCP risk back to those firms, which in turn could “lead to a self-reinforcing [destabilising] feedback loop” in “periods of stress.” Umar Faruqui, Wenqian Huang & Előd Takáts, *Clearing Risks in OTC Derivatives Markets: The CCP-Bank Nexus*, BIS Q. REV., Dec. 2018, at 73, 74-78; see also *id.* at 78 (observing that a “handful of systemically important banks typically comprise the main clearing members”). Because of this potential for a self-reinforcing feedback loop, “the risks of banks and CCPs should be considered jointly, rather than in isolation.” *Id.* at 74. Faruqui, Huang, and Takáts emphasize though that their findings “should not be used to assess the relative merits of central and bilateral clearing.” *Id.*

¹⁶⁴ This can help a CCP avoid illiquidity, especially by requiring clearing members to post variation margin on a daily basis depending on changes in the counterparties’ positions. Sergei A. Davydenko, *Insolvency, Illiquidity, and the Risk of Default 1-6* (Feb. 2013) (unpublished manuscript) (available at <http://www-2.rotman.utoronto.ca/davydenko/liquidity.pdf> [<https://perma.cc/35DR-CXPB>]).

¹⁶⁵ This creates an incentive for each clearing member to monitor the creditworthiness of the other clearing members. Cf. Cox & Steigerwald, *supra* note 15, at 11 (arguing that “the mutualized risk characteristic of the CCP” incentivizes clearing members to take active steps to try to reduce the CCP’s risk).

¹⁶⁶ NORMAN, *supra* note 6, at 10. A risk-management officer of a large CCP observed at a Federal Reserve conference attended by the author that, in his experience, clearing members are ordinarily required to prefund one assessment and are subject to one additional assessment, after which they could choose to resign from membership.

To further minimize default risk,¹⁶⁷ a CCP may buy protection to hedge its payment obligations.¹⁶⁸ To cover a worst-case scenario where these measures are insufficient and the CCP faces insolvency or illiquidity,¹⁶⁹ U.S. law at least gives CCPs that are classified as financial market utilities (FMUs) access to central bank emergency funding.¹⁷⁰

Many of these protections would apply to CCPs equally whether they clear derivatives contracts or nonderivative financial contracts. For example, the distinction between those contracts is irrelevant both to a CCP's ability to buy protection to hedge its potential obligations to pay a net aggregate liability¹⁷¹ and to a clearing member's responsibility to maintain sufficient collateral to reimburse the CCP for payment of its individual counterparty obligations.¹⁷² Similarly, that distinction is irrelevant to a central bank's decision to grant CCPs access to central bank emergency funding.¹⁷³

The distinction between those contracts might be relevant, however, to certain protections against CCP risk concentration. For example, recall that CCPs used to clear derivatives contracts typically grant central clearing services to only a relatively small number of well-capitalized large financial institutions, which assume various responsibilities to help support the CCP's

¹⁶⁷ Through multilateral netting, a CCP normally also has the right to periodically net and set off its clearing members' aggregate counterparty rights and liabilities, so the CCP is only required to make a payment if there is a net aggregate liability. The extent to which this actually reduces risk—or at least, systemic risk—is somewhat uncertain. See *supra* note 121 and accompanying text.

¹⁶⁸ For example, if the Chicago Mercantile Exchange's CCP, CME Clearing Services, assumes responsibility to clear a CDS contract that covers the risk of a commodities trade, CME Clearing Services may itself choose to hedge that risk by purchasing protection under a corresponding CDS contract.

¹⁶⁹ Insolvency means that the CCP's liabilities exceed the value of its assets whereas illiquidity means that the CCP does not have enough cash or near-cash assets to pay its current liabilities as they come due. A CCP thus can be illiquid without being insolvent, and vice versa. CCP illiquidity is the more common and pressing issue because an illiquid CCP cannot pay all of its counterparty obligations. Insolvency is often difficult to determine because asset valuation in a financially distressed situation is often hotly contested, including whether to value the assets at their going-concern or their liquidation value. See, e.g., Matthew C. Klein, *Illiquid, Insolvent, What's the Difference?*, FIN. TIMES: ALPHAVILLE (Sep. 30, 2014, 3:50 PM), <https://ftalphaville.ft.com/2014/09/30/1988932/illiquid-insolvent-whats-the-difference> [<https://perma.cc/E6BP-VJNP>].

¹⁷⁰ Section 806(b) of the Dodd-Frank Act gives the Federal Reserve power to provide discount-window lending, a form of liquidity, to FMUs “in unusual or exigent circumstances.” Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 806(b), 124 Stat. 1376, 1811 (2010) (codified at 12 U.S.C. § 5465(b) (2012)).

¹⁷¹ Cf. *supra* note 168 and accompanying text (discussing the purchase of hedging protection).

¹⁷² For loan agreements, requiring clearing members to post variation margin depending on changes in the counterparties' positions might be tied to changes in borrowers' creditworthiness as evidenced by any downgrades of their senior debt credit ratings. Cf. BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, HIGH-LEVEL SUMMARY OF BASEL III REFORMS 2 (2017), https://www.bis.org/bcbs/publ/d424_hlsummary.pdf [<https://perma.cc/D9CX-LAQV>] (summarizing and comparing the use of credit ratings to assess credit risk under the Basel III and their predecessor (Basel II) capital-adequacy requirements).

¹⁷³ Cf. *supra* notes 169–71 and accompanying text (discussing central bank emergency funding).

financial integrity.¹⁷⁴ Limiting CCP clearing membership in that way does not appear to impede central clearing of standardized derivatives contracts because most parties to such contracts are in fact well-capitalized large financial institutions.¹⁷⁵ That limitation, however, might impede central clearing of nonderivative financial contracts with smaller or less well-capitalized firms as counterparties.¹⁷⁶ For CCPs used to clear those nonderivative financial contracts, these “member-provided” protections would need to be adapted.

Fortuitously, a recent study by the U.S. Office of Financial Research suggests how to adapt member-provided protections to smaller or less well-capitalized firms as counterparties. The study considers whether central clearing of repo transactions,¹⁷⁷ which currently occurs for transactions between dealers, should be expanded to also cover transactions between dealers and nondealers.¹⁷⁸ It assumes that only the dealers are CCP clearing members.¹⁷⁹ It also recognizes, as does this Article, that member-provided protections are needed to help offset the CCPs’ increased risk concentration.¹⁸⁰ The study suggests that, to “ensure that [a] CCP could withstand potential losses from [nondealer] defaults,” its clearing members should make “additional funding contributions” to the CCP.¹⁸¹ That same approach—requiring the CCP clearing members to make any additional funding needed to support the CCP’s financial integrity—could also be used to protect CCPs that clear nonderivative financial contracts.¹⁸²

¹⁷⁴ See *supra* notes 162–67 and accompanying text.

¹⁷⁵ Cf. OFFICE OF THE COMPTROLLER OF THE CURRENCY, QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITY 3 (2016), [https://www.occ.gov/topics/capital-markets/financial-markets/derivatives/pub-derivatives-quarterly-qtr3-2016.pdf](https://www OCC.gov/topics/capital-markets/financial-markets/derivatives/pub-derivatives-quarterly-qtr3-2016.pdf) [<https://perma.cc/GZL9-SUFA>] (reporting that “[a] small group of large financial institutions continues to dominate derivative activity in the U.S. commercial banking system”).

¹⁷⁶ For example, a borrower on a loan agreement could be a medium-sized company, or a large company that is less well capitalized than a financial institution. The minimum-potential-payment-obligation limitation may well exclude the need to centrally clear smaller loans. See *supra* note 95 and accompanying text.

¹⁷⁷ For an explanation of repo transactions, see *supra* text accompanying notes 71–72.

¹⁷⁸ See BAKLANOVA, DALTON & TOMPAIDIS, *supra* note 78, at 3.

¹⁷⁹ See *id.* (observing that “[e]xpanding access to repo CCPs would involve centrally clearing bilateral transactions between dealers, who are members of CCPs, and their clients (nondealers), who are not members”).

¹⁸⁰ See *id.* (observing that if “a repo CCP were expanded to process repo transactions involving nondealers, the exposures of the CCP would increase”).

¹⁸¹ *Id.*

¹⁸² The Office of Financial Research study uses a model in which “dealers would clear and guarantee transactions with the CCP on behalf of their [nondealer] clients.” *Id.* at 5. The discussion above assumes that CCP clearing of nonderivative financial contracts follows that model.

B. *Enhancing the Protections*

Another question is whether the protections against CCP risk concentration could be enhanced. From the standpoint of enhancing protection, nothing appears to distinguish CCPs used to clear derivatives contracts from CCPs used to clear nonderivative financial contracts. However, because centrally clearing nonderivative financial contracts would greatly expand the use of CCPs, regulators might consider more proactively protecting them—regardless of which contracts they clear.

Ringfencing represents at least one way to more proactively protect CCPs. Ringfencing refers to using regulation and contracting to “legally deconstruct[] a firm in order to more optimally reallocate and reduce risk.”¹⁸³ This can consist of “separating risky assets from the firm, . . . preventing the firm itself from engaging in risky activities or investing in risky assets, or . . . protecting the firm from affiliate and bankruptcy risks.”¹⁸⁴ In the context of a CCP, this might involve limiting dividends and other payments to affiliates¹⁸⁵ and making the CCP part of a bankruptcy-remote structure.¹⁸⁶

Because it is costly, ringfencing is most applicable to protect monopoly or semimonopoly entities, which have few if any substitutes, that provide essential public services; thus, it is commonly used to protect public utilities that produce and disseminate electric energy.¹⁸⁷ This is especially valuable where the utility is part of a holding company or other corporate structure that involves nonutility risk, such that insulation of the utility from that risk helps to assure unimpaired continuation of the public services.¹⁸⁸

CCPs, like public utilities, provide essential public services—in the case of CCPs, by (arguably) reducing systemic risk and thus ensuring the ongoing operation of the financial system. Also, like public utilities, CCPs have few if any substitutes;¹⁸⁹ indeed, they are often best situated to perform clearing services.¹⁹⁰ Furthermore, CCPs are often part of a corporate structure that involves non-CCP risk. Ringfencing would be especially valuable in that last context.

For example, ICE Clear Credit, a CCP that provides central counterparty clearing services for CDS contracts, is an indirect subsidiary of

¹⁸³ Steven L. Schwarcz, *Ring-Fencing*, 87 S. CAL. L. REV. 69, 72 (2013).

¹⁸⁴ *Id.*

¹⁸⁵ *Id.* at 77-78.

¹⁸⁶ *Id.* at 76.

¹⁸⁷ *Id.* at 105-06.

¹⁸⁸ *Id.* at 74.

¹⁸⁹ Cox & Steigerwald, *supra* note 15, at 14 (observing that “there are few substitutes for most systemically important CCPs”).

¹⁹⁰ See, e.g., FIN. STABILITY OVERSIGHT COUNCIL, 2012 ANNUAL REPORT 157, 160, 174 (2012), <https://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf> [<https://perma.cc/56V4-E8PV>].

Intercontinental Exchange, Inc.¹⁹¹ Intercontinental Exchange, Inc. engages in an aggressive acquisition strategy¹⁹² that has caused it to incur significant debt,¹⁹³ and “[m]any aspects of [its] business . . . [also] involve substantial risks of liability.”¹⁹⁴ Ringfencing ICE Clear Credit would help to protect it from its parent company’s financial and operating risks, thereby assuring continued performance of the CCP’s clearing services even if the parent fails.¹⁹⁵

Using ringfencing to more proactively protect CCPs would reduce systemic costs but increase transaction costs. If the reduction of systemic costs is greater than the increase in transaction costs, ringfencing would make central clearing of nonderivative financial contracts even more likely to satisfy a cost–benefit balancing.

V. JURISPRUDENTIAL PERSPECTIVES

This Article has analyzed whether regulators should expand the central clearing requirement to include nonderivative financial contracts. The very idea that regulators should require financial institutions to centrally clear their financial contracts—whether derivatives or nonderivative contracts—raises fundamental questions about the justification for financial regulation. Analytically, this Article so far has utilized the standard justification: that financial regulation is justified if its benefits exceed its costs.¹⁹⁶ This Part V examines that justification in more depth. To that end, Section V.A examines whether regulators should mandate how financial institutions control their risk. Section V.B then examines whether regulators should require financial institutions to mutualize risk.

¹⁹¹ *Id.* at 172.

¹⁹² See INTERCONTINENTAL EXCH., INC., 2016 ANNUAL REPORT 29 (2017), <http://ir.theice.com/-/media/Files/I/Ice-IR/annual-reports/2016/2016-annual-report.pdf> [https://perma.cc/FA2K-QF82] (“We may be very acquisitive.”).

¹⁹³ See *id.* at 31 (“Following our acquisition of NYSE and Interactive Data, we have a significant amount of indebtedness outstanding on a consolidated basis.”).

¹⁹⁴ See *id.* at 33 (“Many aspects of our business . . . involve substantial risks of liability For example, dissatisfied market participants that have traded on our electronic platform . . . may make claims regarding the quality of trade execution, or allege improperly confirmed or settled trades, abusive trading practices, security and confidentiality breaches, mismanagement or even fraud against us or our participants An adverse resolution of any lawsuit or claim against us may require us to pay substantial damages”).

¹⁹⁵ As another example, CME Clearing, a CCP that clears the vast majority of the derivatives contracts for U.S. futures, options on futures, and commodity options, is an unincorporated division of the Chicago Mercantile Exchange. FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 190, at 157. Ringfencing CME Clearing could help to insulate it from exchange-related risks, thereby assuring unimpaired continuation of its clearing services even if the exchange fails.

¹⁹⁶ See *supra* notes 77, 84 and accompanying text.

A. *Should Regulators Mandate How Financial Institutions Control Their Risk?*

The standard justification for financial regulation presents a puzzle, at least when applied to risk taking by sophisticated financial institutions: Why would the benefits of financial regulation ever exceed its costs? In principle, those institutions should know best how to control their own risk. To the extent they are protecting their investors, they also have incentives to control that risk. For these reasons, bank regulation “rarely mandates a specific way [for a financial institution] to mitigate risk, ie [sic] whether to take out insurance or to take assets as collateral, etc.”¹⁹⁷

The primary goal of financial regulation, however, should be to correct market failures.¹⁹⁸ Regulation that corrects a market failure might well provide benefits that exceed the regulation’s costs. Risk taking by sophisticated financial institutions can be subject to market failures, most typically evidenced by externalities.¹⁹⁹ For example, government deposit insurance is commonly seen as distorting a deposit-taking bank’s control of risk. Such insurance increases risk taking because if the bank fails, much of the cost of its failure would be externalized onto the government and taxpayers.²⁰⁰

To help control that risk taking, regulators commonly impose capital requirements on banks.²⁰¹ Most notably, the Basel Accords require banks to maintain minimum equity (or “capital”) levels tied to their loan exposure, in order to protect them against unexpected losses.²⁰² The scholarship on

¹⁹⁷ Peter O. Mülbert, *Managing Risk in the Financial System*, in THE OXFORD HANDBOOK OF FINANCIAL REGULATION 365, 395 (Niamh Moloney, Eilís Ferran & Jennifer Payne eds., 2015).

¹⁹⁸ See, e.g., DAVID GOWLAND, THE REGULATION OF FINANCIAL MARKETS IN THE 1990S 21 (1990) (characterizing regulating markets to correct market failure as the “public interest theory”); cf. PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, ECONOMICS 756 (15th ed. 1995) (defining market failure as an “imperfection in a price system that prevents efficient allocation of resources”).

¹⁹⁹ Although economists often categorize externalities as a type of market failure, externalities more precisely are caused by market failures. Steven L. Schwarcz, *Regulating Shadows: Financial Regulation and Responsibility Failure*, 70 WASH. & LEE L. REV. 1781, 1799–1800 (2013).

²⁰⁰ See, e.g., Robert L. Hetzel, *Should Increased Regulation of Bank Risk-Taking Come from Regulators or from the Market?*, 95 ECON. Q. 161, 166 (2009) (illustrating that “[a] financial safety net constituted by deposit insurance” can lead to market failure because “[i]n good times, bank shareholders do well, while in extremely bad times the insurance fund bails out the bank’s depositors and debtholders”). Deposit insurance might also cause market failure by “worsen[ing] the incentives of depositors to monitor bank risk strategy.” GIANNI DE NICOLÒ ET AL., INT’L MONETARY FUND, EXTERNALITIES AND MACROPRUDENTIAL POLICY 6 (2012), https://www.elibrary.imf.org/view/IMF006/12825-9781475504095/12825-9781475504095/12825-9781475504095_A001.xml [<https://perma.cc/LXT3-AXZS>].

²⁰¹ See, e.g., George J. Benston & George G. Kaufman, *The Appropriate Role of Bank Regulation*, 106 ECON. J. 688, 688, 694–96 (1996) (concluding that bank capital regulation is necessary “to reduce the negative externalities resulting from government-imposed deposit insurance”).

²⁰² Kern Alexander & Steven L. Schwarcz, *The Macroprudential Quandary: Unsystematic Efforts to Reform Financial Regulation*, in RECONCEPTUALISING GLOBAL FINANCE AND ITS REGULATION 127, 134–35 (Ross P. Buckley et al. eds., 2016).

controlling financial institution risk taking is relatively limited however,²⁰³ focusing mostly on bank capital regulation.²⁰⁴ That scholarship has little relevance to this Article's focus on regulation requiring central clearing.²⁰⁵

Regulation requiring central clearing addresses a different market failure that causes externalities. Systemically important firms, by virtue of their systemic importance, may be motivated to engage in excessive risk taking. They would profit by, and therefore internalize the benefits of, successful risk taking; whereas if their risk taking fails, they either would be bailed out by the government (thereby externalizing losses onto the government and taxpayers)²⁰⁶ or would externalize much of the systemic harm of their failure onto other market participants and the public.²⁰⁷

The primary goal of requiring central clearing should be to correct this market failure to the extent it arises from systemically important firms engaging in financial contracting.²⁰⁸ This Article thus limits its analysis to central clearing of nonderivative financial contracts that have at least one systemically important counterparty.²⁰⁹ Regulation requiring central clearing helps to correct this market failure by reducing the likelihood of a systemically important counterparty's default.²¹⁰ This explains why central clearing regulation is seen as a "notable exception" to the law's reluctance to mandate specific risk-mitigation measures.²¹¹

²⁰³ Cf. Gazi Ishak Kara & S. Mehmet Ozsoy, *Bank Regulation Under Fire Sale Externalities* 2 (Fed. Reserve Bd., Finance and Economics Discussion Series No. 2016-26, 2016) (recognizing that "the guidance from theoretical literature on the regulation of liquidity and the interaction between liquidity and capital regulations is quite limited").

²⁰⁴ See, e.g., Marc Saidenberg & Til Schuermann, *The New Basel Capital Accord and Questions for Research* 2 (Wharton Fin. Insts. Ctr., Working Paper No. 03-14, 2003).

²⁰⁵ Indeed, most of the financial institutions this Article discusses are not even deposit-taking banks. Cf. *Financial Stability Oversight Council: Designations*, U.S. DEP'T OF THE TREASURY, <https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx> [https://perma.cc/8LBW-CAPE] (last updated Mar. 6, 2019, 4:22 PM) (stating that nonbank financial companies and financial market utilities can also be designated as SIFIs). Also, most SIFIs are bank holding companies that do not themselves take deposits. *Id.*

²⁰⁶ See *supra* note 145 and accompanying text.

²⁰⁷ Schwarcz, *supra* note 145, at 770-71; see also Schwarcz, *supra* note 9, at 206 (explaining this externalization of systemic harm as "a type of tragedy of the commons"). It is a tragedy of the commons insofar as market participants suffer from the actions of other market participants; it is a more standard externality insofar as nonmarket participants suffer from the actions of market participants.

²⁰⁸ That is a goal of macroprudential regulation, which (as discussed) refers to financial regulation that is concerned with the fundamental stability of the financial system, in contrast to microprudential regulation which is concerned primarily with the safety and soundness of individual financial institutions. See *supra* note 10.

²⁰⁹ See *supra* text accompanying notes 94-95.

²¹⁰ See *supra* notes 9-11 and accompanying text.

²¹¹ Cf. Mülbart, *supra* note 197, at 395 (observing that central clearing regulation is a "notable exception" to that reluctance under EU law).

The foregoing analysis explains why central clearing can control systemic risk. Next consider mandating central clearing as a means of mutualizing, and thereby limiting, risk.

B. Should Regulators Require Financial Institutions to Mutualize Risk?

This question is effectively a subset of the prior question: if regulators should mandate how financial institutions control risk, should they require those institutions to mutualize risk? Although fully answering this question is beyond this Article's scope, consider the following possible observations for beginning to answer it.

Requiring central clearing through CCPs helps to mutualize default losses.²¹² Federal Reserve economists indeed observe that “[m]utualization of risk is . . . a key distinguishing feature of CCP risk management as compared to bank risk management.”²¹³ Mutualization of risk is a form of private insurance; it generally refers to dividing a risk among multiple parties to reduce the chance that its occurrence will cause significant financial loss to any one party.²¹⁴ Central clearing mutualizes clearing-and-settlement risk among a CCP's clearing members, many of whom are systemically important firms,²¹⁵ by making each responsible for paying specified amounts—such as contributing to a loss-absorbency fund and paying capital assessments as needed to keep the CCP solvent for the benefit of the CCP and its clearing members.²¹⁶ That, in turn, corrects the market failure discussed in Section V.A by reducing the likelihood of any clearing member's default.

But correcting a market failure does not itself justify regulation. As discussed, proposed regulation additionally must satisfy a cost–benefit analysis.²¹⁷ Part III has argued that central clearing may well satisfy that

²¹² See *supra* note 15 and accompanying text.

²¹³ Cox & Steigerwald, *supra* note 15, at 7.

²¹⁴ See Roe, *supra* note 147, at 1660 (“This risk spreading would conceivably stop the first domino from falling. Or, if it falls anyway, the costs of its failure could be dissipated by multiple financial institutions taking a piece of the risk and small part of the loss.”).

²¹⁵ For example, the Options Clearing Corporation's clearing members include Deutsche Bank Securities Inc., Goldman Sachs & Co. LLC, Wells Fargo Securities, LLC, and Citigroup Global Markets Inc. OPTIONS CLEARING CORP., *supra* note 118, at 47. Even if a clearing member is merely an affiliate of a systemically important firm, that firm is likely to support it. Cf. Arthur E. Wilmarth, Jr., *How Should We Respond to the Growing Risks of Financial Conglomerates?* (observing that “banks and other financial institutions have a powerful reputational interest in supporting their troubled nonbank subsidiaries, regardless of the formalities of corporate separation”), in FINANCIAL MODERNIZATION AFTER GRAMM-LEACH-BLILEY 65, 81 (Patricia C. McCoy ed., 2002).

²¹⁶ See *supra* notes 163–67 and accompanying text.

²¹⁷ See, e.g., Sunstein, *supra* note 77, at 263 (explaining that “[c]ost-benefit analysis is best understood as a way for agencies to ensure that their decisions are informed”). Existing law at most requires a traditional cost–benefit analysis. See Schwarcz, *supra* note 98, at 167–68.

analysis, at least when applied to clearing standardized nonderivative financial contracts with one or more systemically important counterparties.

Viewing central clearing as a way to mutualize risk raises a broader issue: would regulators be justified in going beyond clearing risk and requiring, for example, the mutualization of investment risk of systemically important firms? This issue has become important to the regulatory debate over whether to require a general privatized systemic risk fund—such as the Systemic Emergency Insurance Fund proposed by Professors Gordon and Muller²¹⁸ or, by analogy to FDIC deposit insurance, the systemic risk fund subsidized by market-participant premiums proposed by Professor Anabtawi and the author.²¹⁹

From the standpoint of systemically harmful externalities, investment risk appears to be at least as critical as clearing risk. Recall that the counterparty risk that caused Lehman Brothers' failure, which contributed to the financial crisis, arose because of its investments in MBS.²²⁰ Similarly, the counterparty risk that caused AIG's near failure arose under derivatives contracts only because of the collapse of the MBS market.²²¹ Even the so-called Volcker Rule,²²² originally advocated for as a panacea for systemic financial instability,²²³ focuses exclusively on investment risk.²²⁴ The benefits of mutualizing investment risk of systemically important firms should therefore equal or exceed those of mutualizing those firms' clearing risk. If the costs of mutualizing that investment risk are no greater than the costs of mutualizing that clearing risk, regulation requiring that mutualization of investment risk may well be justified.²²⁵

²¹⁸ Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 151, 204-06 (2011).

²¹⁹ See Anabtawi & Schwarcz, *supra* note 147, at 1401-02 (arguing that systemic risk regulation is justified by externalities and that a privatized systemic risk fund can "correct for risk-spillovers in financial markets by requiring firms to take into account the impact of their behavior on systemic stability"); cf. Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951, 1015-23 (2011) (arguing that systemically important firms should be required to pay risk-based insurance premiums which would be used to fund liquidation of failed firms and thus reduce potential bailout costs); Email Attachment from Paolo Saguato, *supra* note 15 (observing that the "mutualisation and privatization of the guarantee fund might push down the line the necessity of a public bailout"). Such a fund would represent a type of private ordering. Schwarcz, *supra* note 48, at 324-29.

²²⁰ See *supra* notes 65-66 and accompanying text.

²²¹ See *supra* notes 65-66 and accompanying text.

²²² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 619, § 13, 124 Stat. 1376, 1620 (2010) (codified at 12 U.S.C. § 1851 (2012)).

²²³ See, e.g., Jeff Merkley & Carl Levin, *The Dodd-Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats*, 48 HARV. J. ON LEGIS. 515, 531-32 (2011).

²²⁴ The Volcker Rule imposes limitations on proprietary trading in order to prevent banks and other systemically important firms from investing in risky assets. Steven L. Schwarcz, *Regulating Financial Change: A Functional Approach*, 100 MINN. L. REV. 1441, 1486 (2016).

²²⁵ Cf. *supra* note 217 and accompanying text (discussing cost-benefit analysis).

Normatively, however, one might question whether proposed financial regulation should be justified merely because it would correct a market failure and satisfy a traditional cost–benefit analysis.²²⁶ Scholars should consider whether regulators should go beyond that traditional analysis and also compare the costs and benefits of alternative reasonable regulatory proposals.²²⁷ For example, even assuming that the anticipated benefits of mutualizing risk through central clearing, or through a systemic risk fund, exceed its anticipated costs, regulators may want to—and perhaps should also be required to—compare the anticipated costs and benefits of reasonable alternatives, such as requiring private hedging against counterparty risk.

CONCLUSION

The United States and many other countries are requiring most derivatives contracts to be cleared through central counterparties. Regulators believe this central clearing requirement reduces counterparty risk, in turn reducing the risk that counterparty failure could trigger a systemic economic collapse. This Article examines whether the law should also require central clearing for nonderivative financial contracts, such as loan agreements, whose aggregate counterparty exposure greatly exceeds that on derivatives contracts.

This Article shows that, contrary to media portrayal, the systemic riskiness of derivatives contracts turns on the nature of their counterparties, not on their inherent nature. This insight indicates that nonderivative financial contracts with systemically important counterparties could also be systemically risky. In theory, requiring those financial contracts to be centrally cleared could therefore help reduce systemic costs arising from that counterparty risk.

Regulation imposing that requirement would be justified only if its overall reduction of systemic costs outweighs the requirement's transaction costs. To reduce transaction costs, this Article proposes that any such regulation be further limited to material nonderivative financial contracts that are standardized. Because nonderivative financial contracts are increasingly being documented in standardized format, this proposal should not unduly limit the benefits of extending central clearing.

In principle, the regulation should also achieve an overall reduction of systemic costs. Central clearing reduces systemic costs arising from the counterparty risk of individual systemically important firms. Although

²²⁶ See *supra* notes 98–101 and accompanying text (observing that such an analysis is satisfied by showing that the anticipated benefits of specific proposed regulation should exceed the regulation's anticipated costs).

²²⁷ The author has separately argued for such a consequence-based inquiry to assess proposed regulation from alternative perspectives. See Schwarcz, *supra* note 98, at 169 (showing that in traditional cost–benefit analysis, “regulators only superficially consider alternatives”).

central clearing can also increase systemic costs by concentrating counterparty risk in CCPs, CCPs used to clear derivatives contracts are significantly protected from that risk concentration. This Article examines how those protections could be adapted to, and possibly also enhanced for, CCPs used to clear nonderivative financial contracts.

Because its cost–benefit balancing is based on rough approximations, an untested premise, and possible differences in the benefits of multilateral netting,²²⁸ this Article does not conclude that regulation should necessarily require central clearing of nonderivative financial contracts. Instead, it argues that if the benefits of centrally clearing derivatives contracts exceed its costs, then the benefits of centrally clearing nonderivative financial contracts might also exceed its costs. This Article’s analysis nonetheless should help regulators think about expanding the central clearing requirement to nonderivative financial contracts. It also helps answer important legal questions about why, and the extent to which, regulators should mandate how financial institutions should control risk, and whether they should require financial institutions to mutualize risk.²²⁹

²²⁸ See *supra* notes 109–23 and accompanying text.

²²⁹ The author is separately examining how the insight that nonderivative financial contracts with systemically important counterparties could also be systemically risky informs derivatives regulation as well as financial regulation more generally.

APPENDIX 1: CENTRALLY CLEARING NONDERIVATIVE FINANCIAL CONTRACTS

This Appendix 1 illustrates how nonderivative financial contracts could be centrally cleared and compares that to the central clearing of derivatives contracts. The comparison shows that, in principle, central clearing would work identically for clearing both types of contracts. In practice however, there would be one difference in clearing: because relatively more counterparties on derivatives contracts are likely to be CCP clearing members, CCPs clearing derivatives contracts could employ more multilateral netting than CCPs clearing nonderivative financial contracts.

A. *Central Clearing of Derivatives Contracts*

Assume that Parties *A* and *B*—both clearing members of a CCP—enter into a derivatives contract and that, on the settlement date a year hence, Party *B* is obligated to pay \$1,000,000 to Party *A*. If this derivatives contract is centrally cleared, the CCP would be obligated to pay that \$1,000,000 to Party *A*. Party *A* thus is subject to the CCP's credit risk, not Party *B*'s credit risk.

Once the CCP pays the \$1,000,000 to Party *A*, the CCP has a reimbursement claim for that amount against Party *B*.²³⁰ Assuming Party *B* pays that amount to the CCP, the CCP is made whole. If Party *B* defaults on paying that amount to the CCP, the CCP might become financially distressed.

To reduce that likelihood of financial distress, the CCP's clearing members set credit criteria with which the CCP must comply when clearing a contract. To mitigate concentrating systemic risk in the CCP, regulators set the capitalization and other requirements by which clearing members support the CCP. Part IV of this Article discusses these criteria and requirements.

B. *Central Clearing of Nonderivative Financial Contracts*

Using this Article's example of a loan agreement as a typical nonderivative financial contract, assume Party *A* makes a \$1,000,000 loan to Party *B*, repayable in a year with 5% interest. At the loan's maturity (i.e., settlement) date, Party *B* is obligated to repay Party *A* \$1,000,000 principal and \$50,000 interest. If this loan agreement is centrally cleared and Party *A* and Party *B* are clearing members, the CCP would be obligated to pay \$1,050,000 to Party *A* on the settlement date. Party *A* thus is subject to the CCP's credit risk, not Party *B*'s credit risk.

Once the CCP pays the \$1,050,000 to Party *A*, the CCP has a reimbursement claim for that amount against Party *B*. Assuming Party *B* pays

²³⁰ See *supra* note 164 and accompanying text.

that amount to the CCP, the CCP is made whole. If Party *B* defaults on paying that amount to the CCP, the CCP might become financially distressed.

To reduce that likelihood of financial distress, the CCP's clearing members set credit criteria with which the CCP must comply when clearing a contract; and to mitigate concentrating systemic risk in the CCP, regulators set the capitalization and other requirements by which clearing members support the CCP. Again, Part IV of this Article discusses these criteria and requirements.

The foregoing comparison shows that central clearing would work identically, in principle, for clearing both derivatives contracts and nonderivative financial contracts. Next consider the difference, in practice, of clearing these different types of financial contracts.

C. Central Clearing's Difference in Practice

This difference would turn on the CCP's ability to engage in multilateral netting. Recall that multilateral netting refers to a CCP's ability to net offsetting payment obligations among its clearing members.²³¹ Because relatively more counterparties on derivatives contracts are likely to be CCP clearing members,²³² CCPs clearing derivatives contracts could employ more multilateral netting than CCPs clearing nonderivative financial contracts. Here's why.

A CCP clearing a derivatives contract between clearing members Party *A* and Party *B* may also be clearing other derivatives contracts involving one or more of these parties and other CCP clearing members, such as Party *C*. If Party *A* owes Party *B* \$1,000,000 and Party *B* owes Party *C* \$1,000,000, Party *B*'s offsetting obligations will be set off (i.e., netted) and Party *A* will simply owe Party *C* the \$1,000,000.²³³ In contrast, a CCP clearing a nonderivative financial contract between clearing members Party *A* and Party *B* is less likely to be clearing other nonderivative financial contracts involving one or more of these parties and other CCP clearing members.

The significance of this difference is unclear, however. Although multilateral netting can increase CCP operational efficiencies,²³⁴ it is less certain that it can reduce systemic risk. Going beyond the sources cited,²³⁵ the author is personally skeptical that multilateral netting reduces systemic risk. The primary argument that it does reduce systemic risk is that it reduces the CCP's aggregate counterparty risk exposure.²³⁶ Thus, in the previous

²³¹ See *supra* notes 109–18 and accompanying text.

²³² See *supra* notes 175–77 and accompanying text.

²³³ See *supra* note 115 and accompanying text.

²³⁴ See *supra* note 123.

²³⁵ See *supra* notes 119–23 and accompanying text.

²³⁶ See *supra* note 119 and accompanying text; *cf. supra* text accompanying note 111 (discussing that multilateral netting allows for the aggregate offset of positions).

paragraph's example,²³⁷ the CCP's aggregate exposure to \$2,000,000 of counterparty risk (owing \$1,000,000 to Party *B* and \$1,000,000 to Party *C*) is reduced to \$1,000,000 (i.e., after multilateral netting, only owing \$1,000,000 to Party *C*).

The possible fallacy of that argument is that it ignores the credit correlations and setoff rights that are inherent in the CCP's chain of making payments. To understand why, compare multilateral netting and bilateral (i.e., the absence of multilateral) netting, in each case based on the prior example. With multilateral netting, after the CCP pays \$1,000,000 to Party *C*, the CCP will seek reimbursement of that amount from Party *A*. If Party *A* reimburses the CCP, the CCP would be fine; but in the unlikely event Party *A* fails to reimburse the CCP, the CCP's financial integrity would be threatened and it would have to seek the backup protections discussed in Part IV of this Article.

With bilateral netting, the CCP would pay \$1,000,000 to Party *B* and \$1,000,000 to Party *C*. After the CCP pays \$1,000,000 to Party *C*, the CCP will seek reimbursement of that amount from Party *B*. Because the CCP just paid that amount to Party *B*, Party *B* would almost certainly be able to pay the reimbursement. Furthermore, as a matter of law, the CCP should have the right to set off the \$1,000,000 it is obligated to pay to and to receive as reimbursement from Party *B*.²³⁸ Party *B* therefore should not present a credit risk to the CCP. Party *A*, however, presents the same credit risk for bilateral as for multilateral netting. After the CCP pays \$1,000,000 to Party *B*, the CCP will seek reimbursement of that amount from Party *A*. If Party *A* reimburses the CCP, the CCP would be fine; but in the unlikely event Party *A* fails to reimburse the CCP, the CCP's financial integrity would be threatened and it would have to seek the backup protections discussed in Part IV of this Article.

²³⁷ See *supra* text accompanying note 233.

²³⁸ See *supra* note 9 and accompanying text (explaining that parties generally have the right to set off mutually offsetting matured obligations).

APPENDIX 2: STANDARDIZING NONDERIVATIVE FINANCIAL CONTRACTS

This Appendix 2 explains how to standardize nonderivative financial contracts. The explanation should start with trying to understand the standardization of derivatives contracts. The meaning of standardizing a derivatives contract is somewhat ambiguous however. The most common interpretation is functional: if a CCP agrees to clear a derivatives contract, that contract is presumed to be standardized.²³⁹ Using this functional definition, a nonderivative financial contract would be presumed to be standardized if a CCP agrees to clear it.

The Committee of European Securities Regulators has subdivided the concept of standardization into three components: legal uniformity, process uniformity, and product uniformity.²⁴⁰ Legal uniformity refers to “standard transaction documentation and definitions.”²⁴¹ Contracts that are documented on ISDA forms are deemed to have legal uniformity.²⁴² Because many nonderivative financial contracts are now documented on ISDA forms,²⁴³ such contracts would likewise be deemed to have legal uniformity. Efforts are also underway to further standardize loan agreements to help streamline the trading of participation interests in loans.²⁴⁴

Process uniformity refers to the use of automated electronic systems to ensure that details of trades, such as transfers of securities and payments therefor, are accurately recorded.²⁴⁵ In the author’s experience, payments on

²³⁹ See, e.g., *Hearing to Examine the Regulation of Over-the-Counter Derivatives: Joint Hearing Before the H. Comm. on Agric. & the H. Comm. on Fin. Servs.*, 111th Cong. 13 (2009) (statement of Hon. Timothy F. Geithner, Secretary, U.S. Dep’t of the Treasury) (“We will employ a presumption that a derivative contract that is accepted for clearing by any central counterparty is standardized.”); INT’L SWAPS & DERIVATIVES ASS’N, *PRODUCT REPRESENTATION FOR STANDARDIZED DERIVATIVES* 4 (2011), <https://www.isda.org/a/EHiDE/product-representation-for-standardized-derivatives-20110414vfinal1.pdf> [<https://perma.cc/UM74-3HF9>] (defining standardized OTC derivatives as “broadly speaking those derivatives that will be centrally cleared or electronically executed”).

²⁴⁰ COMM. OF EUROPEAN SEC. REGULATORS, *STANDARDISATION AND EXCHANGE TRADING OF OTC DERIVATIVES* 6 (2010), https://www.esma.europa.eu/sites/default/files/library/2015/11/10_610.pdf [<https://perma.cc/6JPW-U4R9>].

²⁴¹ *Id.* at 6-7.

²⁴² *Id.*

²⁴³ See *supra* notes 130–32 and accompanying text (observing this is being done to gain the advantage of bankruptcy law’s safe harbor exemptions).

²⁴⁴ BRIDGET MARSH & TED BASTA, *LOAN SYNDICATIONS AND TRADING: AN OVERVIEW OF THE LOAN SYNDICATIONS & TRADING ASSOCIATION AND THE LEVERAGED LOAN MARKET* 1, 7 (2008), <http://apps.americanbar.org/buslaw/committees/CL190000pub/newsletter/200803/marsh.pdf> [<https://perma.cc/L2M2-V568>] (discussing the efforts of the Loan Syndications & Trading Association (LSTA) to create new standard documents to help streamline the trading of loan participations). The LSTA’s own website provides further background on that effort. See *LOAN SYNDICATIONS & TRADING ASS’N*, <https://www.lsta.org/> [<https://perma.cc/QL77-H5TX>].

²⁴⁵ COMM. OF EUROPEAN SEC. REGULATORS, *supra* note 240, at 7-8.

material financial contracts involving sophisticated parties—the subset of contracts this Article discusses—are always recorded through automated electronic systems. All of the nonderivative financial contracts discussed in this Article should therefore have process uniformity.

Product uniformity refers to financial products that have similar features.²⁴⁶ This Article uses loan agreements to exemplify nonderivative financial contracts.²⁴⁷ Because loan agreements have relatively straightforward repayment schedules for principal and interest, they clearly should represent a uniform product class. Indeed, at least one derivatives expert informed the author that loan agreements, as products, tend to be much more uniform than derivatives, in part because sellers want to retain control of the derivatives product market through customization.²⁴⁸

The standardization of nonderivative financial contracts for CCP clearing thus appears to have a very low bar, encompassing at least all such contracts that (as is common) are documented on ISDA forms as well as all such contracts that a CCP in fact agrees to clear. This concept of standardization is very different, for example, from the custom and practice for standardizing letters of credit, which is necessary to enable low-level bank officers to determine, on a real-time basis and without knowledge of nonbanking terminology or the exercise of judgment, whether documents presented by the letter-of-credit beneficiary satisfy the payment conditions.²⁴⁹

²⁴⁶ *Id.* at 9.

²⁴⁷ See, e.g., *supra* note 22 and accompanying text.

²⁴⁸ This observation is based on a discussion with P.R.I.M.E. Finance expert colleagues at the January 22-23, 2018 annual conference in The Hague. These colleagues and the author are members of P.R.I.M.E. Finance's Panel of Recognized International Market Experts in Finance, consisting of the most senior people in the financial markets. See *About Us*, P.R.I.M.E. FIN., <https://primefinancedisputes.org/page/about-us> [<https://perma.cc/UA3R-DH2M>]; cf. RUTTER ASSOCS. LLC, DEMYSTIFYING EXOTIC DERIVATIVES: WHAT YOU NEED TO KNOW (2016), <http://www.rutterassociates.com/wp-content/uploads/2016/06/Demystifying-Exotic-Derivatives-What-You-Need-to-Know.pdf> [<https://perma.cc/KZ3T-QQVT>] (discussing four categories of nonuniform derivatives).

²⁴⁹ See, e.g., U.C.C. art. 5 prefatory note (AM LAW INST. & UNIF. LAW COMM'N 1977) (discussing the need for uniformity); U.C.C. § 5-108 cmts. 1, 8-9 (explaining that UCC Article 5 changed its documentary review standard from "substantial compliance" to "strict compliance" to eliminate the need for bank officers to exercise judgment).